

# 2007 Annual Report to Congress

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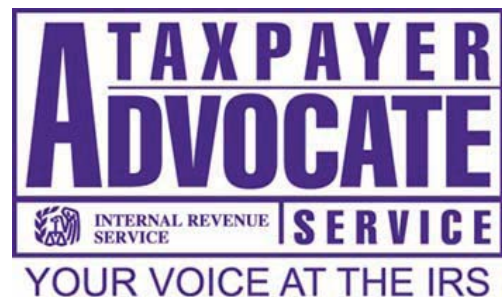
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## NATIONAL TAXPAYER ADVOCATE

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2007 ANNUAL REPORT  
TO CONGRESS

Volume One



National Taxpayer Advocate

2007 Annual Report to Congress

2007

Report to Congress

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*This report is dedicated to the taxpayers of the United States  
who year in and year out  
do their best to comply with complex tax laws and procedures;*

*And to the employees of the Internal Revenue Service  
who every day try to make it a little easier  
for our taxpayers to comply.*

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### ***Honorable Members of Congress:***

I respectfully submit for your review the National Taxpayer Advocate's 2007 Annual Report to Congress. As explained below, this year's report discusses some significant challenges to tax administration – the impact of late-year tax-law changes, the need for a comprehensive approach to cash economy noncompliance, and the future of face-to-face service, to name a few. We also provide status updates on three issues we discussed in previous Annual Reports: Private Debt Collection, IRS Collection Strategy, and Criminal Investigation's Questionable Refund Program.

As in past years, we include a second volume that contains several research studies conducted or commissioned by the Taxpayer Advocate Service. The studies in this year's Volume 2 provide support for several themes running throughout the report:

- The need to take a strategic approach to solving major tax administration challenges;
- The need to better understand taxpayer behavior and the causes of noncompliance;
- The need to better understand the influence tax preparers and practitioners have on compliance and noncompliance; and
- The need to design services, communications, and compliance initiatives with the specific characteristics of the target population in mind.

Among other things, the above themes are reflected in our legislative recommendation for Congress to enact a Taxpayer Bill of Rights, by which we mean a charter that explicitly sets out the rights and responsibilities of U.S. taxpayers. Such a document can only improve tax compliance by clearly stating both what taxpayers have the right to expect from the tax system and what taxpayers, in turn, owe to their government.

### ***Significant Challenges to Tax Administration***

First and foremost, both taxpayers and tax administrators need certainty. The constant changing of tax laws and procedures confuses taxpayers and leads to their making errors or not claiming deductions or credits to which they are entitled under the law. For the IRS, changes in tax laws require programming and process changes, retraining employees, and revising tax forms, instructions, and publications. When such changes are enacted late in the calendar year, there is insufficient time before the start of the filing season to update IRS systems and to conduct the necessary taxpayer education. We saw the real-world impact of late-in-the-year changes during the 2007 filing season, when Congress enacted "extenders" of several tax benefits for middle class taxpayers. It appears that more than a million taxpayers did not claim tax deductions to which they were entitled because they were not mentioned on Form 1040 or the accompanying instructions or included in shrink-wrapped software programs. We will have to wait to see what the impact is of the late year "AMT patch" on taxpayers claiming the Child and Dependent Care Credit or other credits during the upcoming 2008 filing season. But

history tells us that many affected taxpayers will not claim these credits, despite claiming them in prior years.

Although easier said than done, the solution to this situation is straightforward: the IRS should inform Congress, explicitly and directly, by the middle of the calendar year about (1) the provisions in current law that are sunsetting that year; (2) the impact on taxpayers if such provisions are not extended; (3) the date by which legislation must be enacted in order for the IRS to complete all programming and training before the start of the filing season; and (4) the impact on the filing season if Congress enacts the extenders after that date but before the filing season. The IRS should provide monthly updates, if warranted, beginning in September. With the benefit of that information, Congress should take action by the date that will ensure a smooth filing season.

In our report, we also highlight the issue of cancellation of indebtedness income. This issue received considerable attention in 2007 as homeowners defaulting on subprime mortgages were poised to receive hefty tax bills. Congress enacted legislation in December temporarily exempting most debts cancelled in connection with home foreclosures from tax, yet the fact remains that approximately two million Forms 1099 reporting COD income are issued to taxpayers annually. Common causes are defaults on automobile loans or credit card bills. Our review concluded that the IRS has done little to advise these taxpayers about various exclusion provisions, including the insolvency exception. The IRS has also declared the preparation of returns involving canceled debt issues to be “out of scope” for Taxpayer Assistance Centers (TACs). If this issue is too complex for IRS employees (or VITA volunteers) to handle in preparing returns, how are taxpayers – especially low income taxpayers who cannot afford to pay for return preparation – going to be able to report their income correctly? It is likely that the IRS’s short-sighted decision to declare canceled debt issues “out of scope” will result in many more Automated Underreporter notices later in the year, as taxpayers simply omit this confusing income item. With better outreach and assistance, we could avoid this situation.

### ***The Need to Take a Strategic Approach to Solving Major Tax Administration Challenges***

In the report, we propose a comprehensive strategy to address the cash economy, which is the largest portion of the tax gap.<sup>1</sup> We recognize that many commentators believe that it is neither possible nor practical to close this portion of the tax gap. While we agree with this statement with respect to *eliminating* the cash economy tax gap, we believe that the cash economy tax gap can be significantly *reduced*. We need a strategic, comprehensive approach that identifies particular areas of noncompliance and develops the administrative and legislative tools necessary to reduce that noncompliance without imposing undue compliance burdens. In this report – in the Most Serious Problem and the Key Legislative Recommendation about the cash

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<sup>1</sup> Although there is no universally agreed-upon definition of “cash economy,” we use the term to mean taxable income from legal activities that is not reported to the IRS by third parties. This definition can include businesses dealing strictly in cash as well as others that handle a portion of their transactions in cash or receive other payments not subject to information reporting. For example, a retailer who receives most of his revenue through debit and credit cards can be considered part of the cash economy because these forms of payment are not subject to information reporting.

economy and in the comprehensive strategy set forth in Volume 2 – we propose the beginnings of such a plan. To achieve progress in this area, however, the IRS must first acknowledge that it does not now have a strategic plan to address the cash economy and that what it is doing in this area is *ad hoc*. Unfortunately, in its response to our Most Serious Problem discussion, the IRS acknowledges no such thing. If the IRS mistakenly believes it now has a strategic plan, it is unlikely to take the bold steps required to develop one. It is particularly disturbing that, for the third year running, the IRS declines to create a Cash Economy Program Office to coordinate its various initiatives. *Ad hoc* measures will not get the job done.

### *The Need to Better Understand Taxpayer Behavior and the Causes of Noncompliance*

For a tax administrator to maintain and improve taxpayer compliance, he or she must first understand what factors influence taxpayer behavior and what causes noncompliance. Such an understanding must go beyond merely categorizing behavior as “intentional” or “unintentional” and instead requires a more sophisticated analysis. In our Volume 2 study titled “IRS Earned Income Credit Audits – A Challenge to Taxpayers,” for example, we report on the results of surveys and focus groups of EITC taxpayers and their representatives, respectively, who were involved in EITC audits. The study shows that many of the reasons for inaccurate audit results and, by extension, noncompliance are attributable to the particular characteristics of the EITC population. However, a great number of these reasons can be minimized or eliminated by factors and processes within the control of the IRS, such as clearer notices and instructions. In fact, the Most Serious Problem “EITC Examinations and the Impact of Taxpayer Representation” shows that the IRS has improved its EITC examination processes significantly and has applied many of the findings from recent studies of the EITC audit process, even as there is more work to be done in this area.

Tax administrators in today’s complex world must be flexible and willing to use new tools and disciplines to address the age-old problem of noncompliance. In this report, we discuss a few such approaches. The National Taxpayer Advocate commissioned two research studies – one, by Professor Marjorie Kornhauser, to review the state of scholarship on why taxpayers do what they do and the impact of “taxpayer morale” on compliance; and the second, by Professor Kathleen M. Carley, to use agent-based modeling to predict taxpayer behavior in a given situation. Professor Kornhauser’s report led us to recommend that the IRS develop an applied research lab that could conduct empirical studies of taxpayer behavior and understanding, the results of which would enhance service and enforcement initiatives. (See Most Serious Problem, “Taxpayer Service and Behavioral Research.”) Professor Carley’s work, by replicating in a modeling environment the results of the Tax Year 2004 Hartford EITC Certification test, enabled us to test various scenarios and better understand the impact of positive and negative messages on taxpayer behavior. While neither of these studies is conclusive – they raise as many questions as they answer – they demonstrate the importance and value of using new technologies and different disciplines to improve tax compliance. Congress needs to encourage and fund the IRS’s exploration of these approaches.

### ***The Need to Better Understand the Influence Tax Preparers and Practitioners Have on Compliance and Noncompliance***

More than 62 percent of individual tax returns are now prepared by paid preparers. It stands to reason that these preparers can influence their clients' compliance or noncompliance with the tax laws.<sup>2</sup> Similarly, tax practitioners who are authorized to practice before the IRS (known as "Circular 230" practitioners) can also affect how their clients view and fulfill their tax obligations.

In this report, we explore several issues relating to preparers and Circular 230 practitioners. As with all of our discussions and research, we hope to improve tax administration by going beyond superficial discussions of "good" and "bad" taxpayers or preparers and instead look at the impact of representation, the methods of regulating preparer and practitioner behavior, and the protection of taxpayer information in the hands of these professionals.

First, in three Most Serious Problem discussions, we consider the regulation of Circular 230 practitioners, the application of preparer penalties and preparer "bypass" procedures, and the use and disclosure of tax return information by preparers. Second, we report on a TAS study of the impact of representation on the outcome of EITC audits. As we discuss in the Most Serious Problem "EITC Examinations and the Impact of Taxpayer Representation" and the corresponding Volume 2 research study titled "IRS Earned Income Credit Audits – A Challenge to Taxpayers," represented taxpayers are twice as likely as unrepresented taxpayers to be found eligible for EITC and to have no changes made to their EITC as a result of an examination. Moreover, represented taxpayers retained, on average, \$623 more in EITC than unrepresented taxpayers. Finally, in Volume 2 we present a study by Professor Leslie Book, "Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws," that reviews the literature relating to tax practitioners' influence on tax compliance and considers a typology of the practitioners' role in sole proprietor and EITC noncompliance.

### ***The Need to Design Services, Communications, and Compliance Initiatives with the Specific Characteristics of the Target Population in Mind***

I commend the IRS for its progress in understanding the needs and preferences of individual taxpayers, its creation of a Taxpayer Service Executive Steering Committee and TAB Program Management Office, and its commitment to research the impact of taxpayer service on compliance as part of its Taxpayer Assistance Blueprint. As highlighted in the Most Serious Problem discussions titled "Exempt Organization Outreach and Education," "Outreach and Education on Disability Issues for Small Businesses/Self-Employed Taxpayers," and "Nonfiler Program," the IRS now needs to expand this analysis to other taxpayer segments and specific taxpayer populations. Moreover, it must apply some of its preliminary findings from the TAB

<sup>2</sup> See generally Government Accountability Office, GAO-06-563T, *Paid Tax Return Preparers: In A Limited Study, Chain Preparers Made Serious Errors* (2006). This study focused on tax returns prepared by paid tax return practitioners at 19 different sites. GAO staff posed as taxpayers and had tax returns prepared by practitioners at the different sites. Errors were made on all 19 returns ranging from small misstatements that had little or no effect on the tax liability to large mistakes that would have resulted in significant overpayments or underpayments of tax.



and other surveys to its current service offerings. For example, the IRS now acknowledges that there will always be a part of our taxpayer population that requires – not just prefers – face-to-face service in order to comply with the tax laws. The next step is to ensure that Taxpayer Assistance Centers are adequately staffed to meet the needs of that population and adequately trained to answer the questions most likely to be asked by that population. By declaring certain subjects or services “out of scope” at the TACs, the IRS may be reducing its “wrong answer” rate, but that approach hardly serves taxpayers who come to the TACs looking for assistance. Different taxpayer populations in different geographic locales have different needs for assistance. A 21st century tax administrator can accept the challenge of meeting those needs, first by listening to taxpayers and second by utilizing technology – not only the Internet and telephones, but also kiosks in TACs for converting cash to money orders and mobile tax assistance units that travel to taxpayers in their communities.

### *Why a Taxpayer Bill of Rights?*

To my mind, tax compliance in the United States occurs because, by and large, taxpayers want to comply with the tax law. They view themselves as civilized folk who understand that “taxes are what we pay for civilized society.”<sup>3</sup> But this willingness to comply is directly related to the way in which the tax system treats its taxpayers.

I believe taxpayers and tax administration will benefit from an explicit statement of what taxpayers have a right to expect from their government’s tax system and what the government has a right to expect from its taxpayers. This expression of the social contract between taxpayers and their government will enable taxpayers and administrators alike to understand the fundamental principles upon which all taxpayer protections and responsibilities are built. Our present hodgepodge of taxpayer rights, enacted over three decades of legislation, can be linked to these fundamental rights, and these rights, in turn, will rest on corresponding taxpayer responsibilities. This clarity of expression and structure can form the basis of a national dialogue of what it means to be the “lifeblood of government” – that is, the U.S. taxpayer. With a greater awareness of one’s rights and responsibilities, taxpayer compliance may well increase.

Respectfully submitted,



Nina E. Olson  
National Taxpayer Advocate  
31 December 2007

<sup>3</sup> See *Compania General de Tabacos de Filipinas v. Collector of Internal Revenue*, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting).

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**Volume II**

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## Introduction: The Most Serious Problems Encountered by Taxpayers

Internal Revenue Code (IRC) § 7803(c)(2)(b)(ii)(III) requires the National Taxpayer Advocate to prepare an Annual Report to Congress which contains a summary of at least 20 of the most serious problems encountered by taxpayers each year. For 2007, the National Taxpayer Advocate has identified, analyzed, and offered recommendations to assist the IRS in resolving 26 such problems. Additionally, this year's report includes status updates on three issues discussed in prior Annual Reports – the IRS's Private Debt Collection (PDC) initiative, the IRS's collection strategy, and the Questionable Refund Program (QRP), operated by the IRS's Criminal Investigation (CI) division.<sup>1</sup> Although the IRS has made several notable improvements within each of these previously reported upon areas, we are providing a status report on both the work accomplished and the challenges ahead as the IRS continues to address the problems we identified.

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

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

### Methodology of the Most Serious Problem List

The National Taxpayer Advocate considers a number of factors in identifying, evaluating, and ranking the most serious problems encountered by taxpayers. The 26 issues and three status updates contained in this section of the Annual Report were ranked according to the following criteria:

<sup>1</sup> See National Taxpayer Advocate 2006 Annual Report to Congress, Most Serious Problem: *True Costs and Benefits of Private Debt Collection* 34-61; Most Serious Problem: *Early Intervention in IRS Collection Cases*, 62-82; Most Serious Problem: *IRS Collection Payment Alternatives*, 83-109; Most Serious Problem: *Levies*, 110-129; Most Serious Problem: *Centralized Lien Processing* 130-140; Most Serious Problem: *Collection Issues of Low Income Taxpayers*, 141-156; and Status Update: *Major Improvements in the Questionable Refund Program and Some Continuing Concerns* 408-421.

- Impact on taxpayer rights;
- Number of taxpayers affected;
- Interest, sensitivity, and visibility to the National Taxpayer Advocate, Congress, and other external stakeholders;
- Barriers these problems present to tax law compliance, including cost, time, and burden;
- The revenue impact of noncompliance; and
- Taxpayer Advocate Management Information System (TAMIS) data.

Finally, the National Taxpayer Advocate and the Office of Systemic Advocacy examine the results of this ranking and adjust it where editorial or numeric considerations warrant a particular placement or grouping.

### **Taxpayer Advocate Management Information System (TAMIS) List**

The most serious problems reflect not only the mandates of Congress and the IRC, but TAS's integrated approach to advocacy – using individual cases as a means for detecting trends and identifying systemic problems in IRS policy and procedures or the Code. TAS tracks individual taxpayer cases on the TAMIS system. The top 25 case issues, which are listed in Appendix 1, reflect TAMIS receipts based on taxpayer contacts in fiscal year (FY) 2007, a period spanning October 1, 2006, through September 30, 2007.

### **IRS Responses**

TAS provides the IRS's respective operating divisions and functional units with the opportunity to comment on and respond to the problems described in each year's report. These responses appear unedited, under the heading "IRS Comments", followed by the National Taxpayer Advocate's own comments and recommendations.

### **Use of Examples**

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



MSP  
#1

## The Impact of Late-Year Tax-Law Changes on Taxpayers

### Definition of Problem

The National Taxpayer Advocate believes that the frequency and magnitude of late-year tax law changes has become the most serious problem facing taxpayers. It is also the most significant problem facing the IRS. This year, considerable attention has focused on the delays the late enactment of the “AMT (Alternative Minimum Tax) patch” is likely to cause. But late-year tax law changes are not new. The purpose of this section is to highlight the burdens that late-year changes impose on taxpayers.

By designating late-year tax-law changes as the most serious problem, the National Taxpayer Advocate is seeking to raise awareness about the impact such changes can have on the tax system, and on taxpayers in particular, so that Congress can give appropriate weight to this consideration as it evaluates the merits of late-year tax legislation in the future.

### Analysis of Problem

#### Background

The IRS’s successful execution of the tax filing season is one of the most important functions any government agency performs. From the government’s perspective, the IRS collects approximately 96 percent of all federal revenue,<sup>1</sup> so the government’s ability to fund other programs depends on the IRS’s success. The filing season is also critical because it represents the most significant interaction that many Americans have with the federal government all year. A good experience therefore improves public perception of the government, and a bad experience has the opposite effect.

For the IRS, delivering a successful filing season requires extensive planning and coordination among numerous functions. The IRS must take the extraordinarily complex Internal Revenue Code, which by now probably exceeds 1.5 million words,<sup>2</sup> and among other things:

1. Develop forms on which taxpayers may report all items of income and claim all authorized tax benefits;

<sup>1</sup> Government Accountability Office, GAO-07-136, *Financial Audit: IRS’s Fiscal Years 2006 and 2005 Financial Statements* 68 (Nov. 2006).

<sup>2</sup> 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, 107<sup>th</sup> Cong., *Study of the Overall State of the Federal Tax System and Recommendations for Simplification*, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986 (vol. I), at 4 (Comm. Print 2001). Subsequent tax legislation has expanded the number of words considerably.

2. Develop instructions for each form;
3. Develop publications that provide comprehensive yet simple explanations of issues that affect large numbers of taxpayers (*e.g.*, the tax consequences of selling property);
4. Develop training materials for IRS telephone assistants, field assistance personnel, and others to help them answer taxpayer questions;
5. Work with tax preparation software developers (*e.g.*, TurboTax manufacturer Intuit and TaxCut manufacturer H&R Block) to ensure that they have adequate guidance to produce accurate products and to ensure that they and others who transmit tax returns to the IRS electronically do so in a format that the IRS can accept;
6. Provide instruction to personnel at Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) sites to ensure that they can prepare accurate tax returns; and
7. Write programming code that allows the IRS to accept returns and that enables the IRS to perform numerous automated reviews of tax returns.

The programming challenges are particularly significant. The IRS processing systems check the math a taxpayer uses in adding lines on a return, separately compute the tax owed, identify both overpayments of tax and underpayments of tax, evaluate returns for indicia of fraud (this system is known as the “Electronic Fraud Detection System”), and provide the data that are later used to match return information against Forms W-2 and Forms 1099 submitted by third-party payors to identify underreporting (this system is known as the Automated Underreporter program).

Because of the magnitude of these challenges, late-year tax law changes may force the IRS to delay the start of the filing season. In general, the filing season begins on or about January 15. In 2006, however, the Tax Relief and Health Care Act was not signed into law until December 20, 2006.<sup>3</sup> It affected tax benefits for more than 11 million taxpayers.<sup>4</sup> As a consequence, the IRS was unable to process returns claiming those benefits until February 3, 2007, which amounted to approximately a three-week delay. In December 2007, Congress passed the Tax Increase Prevention Act, which was not signed into law until December 26, 2007. This legislation raised the AMT exemption amounts for 2007 and extended an ordering rule that applies to personal tax credits.<sup>5</sup> Around the same time, Congress also passed the Tax Technical Corrections Act of 2007,<sup>6</sup> which made modifica-

<sup>3</sup> Pub. L. No. 109-432, 120 Stat. 2922 (2006).

<sup>4</sup> For tax year 2006, IRS data show that 11 million taxpayers claimed the deduction for state and local sales taxes, four million claimed the deduction for post-secondary tuition and fees, and 3.2 million claimed the deduction for educator expenses. IRS Statistics of Income, Individual Income Tax Returns (unpublished analysis as of December 2006). These deductions were authorized for Tax Year 2006 by the Tax Relief and Health Care Act.

<sup>5</sup> H.R. 3996, 110<sup>th</sup> Cong. (2007) (Public Law number not yet assigned).

<sup>6</sup> H.R. 4839, 110<sup>th</sup> Cong. (2007) (Public Law number not yet assigned).

tions to most major tax legislation enacted since 1998, and the Energy Independence and Security Act,<sup>7</sup> which contained several additional tax provisions. The Treasury Department has estimated that the AMT-related legislation affected up to approximately 50 million taxpayers.<sup>8</sup> The IRS projects that the start of the 2008 filing season will be delayed for more than 13 million taxpayers until February 11.<sup>9</sup>

### Impact on Taxpayers

The impact of late-year tax-law changes on taxpayers is significant. The following are some of the principal consequences:

1. *The overwhelming majority of tax returns claim refunds, and the delay in processing returns delays the issuance of refunds to taxpayers, including low income taxpayers who rely on tax refunds to pay essential bills.*

Approximately 80 percent of taxpayers receive a refund when they file their returns.<sup>10</sup> Taxpayers entitled to large refunds – and particularly low income taxpayers who are entitled to earned income tax credit (EITC) benefits – tend to file early in the filing season so they can obtain their refunds quickly. Last year, the filing season started on January 15, and by February 2, the IRS had processed 14.4 million refunds and issued 13.3 million refunds.<sup>11</sup> Thus, among the earliest filers, more than 92 percent received refunds. The average refund amount was just under \$3,000.<sup>12</sup>

Tax refunds are particularly important to low income taxpayers. Among taxpayers who received EITC benefits and received tax refunds in tax year 2005, the average refund amount was \$3,093.46, and the average adjusted gross income was \$15,484.52.<sup>13</sup> Thus, the average refund amounted to 20 percent of each taxpayer's yearly income. A taxpayer for whom the refund is so significant often makes financial plans based on when he or she anticipates receiving the refund and may view the refund as a lifeline. For some taxpayers, a delay of two to four weeks in receiving the refund could mean eviction, inability to pay the high heating bills that arise during winter, or defaulting on credit card bills from the holiday season.

<sup>7</sup> Pub. L. No. 110-140 (2007).

<sup>8</sup> Letter from Henry M. Paulson, Jr., Secretary of the Treasury, to Charles E. Grassley, Ranking Member, Committee on Finance, United States Senate (Oct. 23, 2007).

<sup>9</sup> See IRS News Release IR-2007-209, Filing Season Opens on Time Except for Certain Taxpayers Potentially Affected by AMT Patch, (Dec. 27, 2007).

<sup>10</sup> In FY 2006, the IRS received 133,917,068 Form 1040-series returns and issued 108,011,060 refunds. See IRS Data Book, 2006, Tables 3 & 7. That is, 80 percent of taxpayers had more tax withheld or paid more estimated tax than was required to satisfy their tax liabilities. Less than 20 percent of taxpayers owed a balance to the IRS at the time they filed their returns.

<sup>11</sup> See IRS Oversight Board, *Issue Paper: Impact of Late AMT Legislative Changes on 2008 Filing Season* (Nov. 2007) (citing data from IRS filing season reports).

<sup>12</sup> *Id.*

<sup>13</sup> IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2005).

Nor is the significance of tax refunds limited to EITC recipients. For example, a recent Associated Press story described a law school administrator who was counting on receiving her tax refund in early 2008 to help pay for expensive dental work.<sup>14</sup>

When the start of the filing season is delayed, the delays in issuing refunds to taxpayers who file paper returns can be particularly lengthy. The majority of tax returns are now submitted electronically,<sup>15</sup> and the IRS generally employs only as many individuals to perform manual data entry of paper returns as it expects it will need in a given period of time. If the filing season is delayed by three weeks and data entry employees must wait until February to begin entering a three-week backlog of returns, returns arriving after that date will necessarily be held in a queue until the data entry personnel can get to them.

There is little doubt that delays in the start of the filing season will cause harm to many taxpayers who depend on receiving timely refunds, and for some taxpayers, the magnitude of the harm could be significant.

## ***2. Taxpayers who file paper returns are at risk of filing inaccurate returns.***

The IRS generally must finalize its Form 1040 and Form 1040A and the accompanying instructions in or around the first week of November. These packages are mailed to taxpayers beginning in late December. Significantly, the IRS generally does not update Form 1040 or the accompanying instructions package if the law is changed later in the year. The Form 1040 is the most critical document for purposes of return data entry, and if there were multiple versions of Form 1040, confusion would arise and the IRS would not be able to process returns consistently. Instead, the IRS attempts to get to the correct tax result by revising the various forms that feed into Form 1040 (*e.g.*, Form 2441, Child and Dependent Care Expenses).

However, some tax provisions, particularly deductions, are often reported directly on Form 1040. Therefore, last-minute changes in the law mean that some taxpayers will not obtain updated forms and will file inaccurate returns. For example, there were several tax deductions that were in effect for prior years but expired on December 31, 2005. In December 2006, after the forms and instructions for 2006 had been printed, Congress retroactively extended the deductions as of January 1, 2006.<sup>16</sup> Unlike in prior years, therefore, Form 1040 and its accompanying instructions did not inform taxpayers that these deductions were available. One of the extended deductions was for state and local sales taxes. Compared with 2005, 3.7 percent, or 422,881, fewer taxpayers claimed the deduction in 2006. Another extended deduction was for out-of-pocket expenses incurred by educators for classroom supplies. Compared with 2005, 8.5 percent, or 297,958, fewer taxpayers claimed the deduc-

<sup>14</sup> Jim Abrams, *32 Million Tax Refunds Could Be Delayed*, Associated Press (Dec. 2, 2007).

<sup>15</sup> IRS Document No. 6292 (Spring 2007 update) (indicating that 72,769,506 out of 133,917,068 total returns, or 54.3 percent, were filed electronically in FY 2006).

<sup>16</sup> Tax Relief and Health Care Act, Pub. L. No. 109-432, 120 Stat. 2922 (2006).

tion in 2006. A third extended deduction was for tuition and fees paid to post-secondary institutions. Compared with 2005, 14.2 percent, or 667,054, fewer taxpayers claimed the deduction in 2006.<sup>17</sup> There is no apparent explanation for the decline in the number of taxpayers claiming these tax deductions other than that they did not know about them.

### ***3. Taxpayers who use tax preparation software are at risk of filing inaccurate returns.***

Similar problems may arise when taxpayers purchase shrink-wrapped tax preparation software. Software manufacturers generally deliver their products to merchants in the fall, well before the start of the tax-filing season. Therefore, the software code does not reflect late-year tax-law changes. Software manufacturers generally offer a “patch” that taxpayers may download to update the software, and many taxpayers do, indeed, download the patch. However, some taxpayers do not download patches – whether because of technology limitations (*e.g.*, no Internet connection or lack of knowledge), inadvertence, or overriding concerns that patches downloaded from an Internet site could carry computer viruses. A taxpayer who seeks to file electronically may be precluded from doing so without downloading a patch. This limitation may cause some taxpayers who otherwise would file electronically to file on paper instead. Even apart from this limitation, millions of taxpayers who use software still print their returns and mail them to the IRS, and these taxpayers may end up filing inaccurate returns.<sup>18</sup> Just as with paper returns, taxpayers preparing their returns with software could easily have missed the deductions for state and local sales taxes, educator expenses, and post-secondary tuition and fees.

### ***4. Because most state income tax systems piggyback off federal income tax return computations, taxpayers who make errors on their federal returns as a consequence of late-year changes are likely to make the same errors on their state returns.***

At least 35 states and the District of Columbia currently use federal Adjusted Gross Income or federal taxable income as the starting point for computing state or local tax liabilities.<sup>19</sup> If taxpayers make errors on their federal tax returns because of late-year tax-law changes, these errors will be compounded because they will carry over to their state or local tax returns. This may result in underreporting or overreporting at the state level.

<sup>17</sup> IRS Statistics of Income (SOI), *Individual Income Tax Returns* (unpublished analysis as of December 2006).

<sup>18</sup> In 2007, the IRS received 43.3 million returns that were prepared using computers yet were submitted on paper. IRS Statistics of Income Division, *Tax Year 2006 Taxpayer Usage Study* (Oct. 26, 2007 report).

<sup>19</sup> See Federation of Tax Administrators, *State Personal Income Taxes: Federal Starting Points (as of January 1, 2007)* (available at [http://www.taxadmin.org/fta/rate/inc\\_stp.html](http://www.taxadmin.org/fta/rate/inc_stp.html)).

**5. *Even taxpayers who file accurate returns will experience added burden and confusion working through baffling and counterintuitive instructions.***

Because the IRS does not revise the Form 1040 package after it is finalized in early November, it is sometimes forced to create “workarounds.” As discussed above, the 2006 “extenders” legislation was not enacted until December of that year.<sup>20</sup> To enable taxpayers to claim tax benefits enacted after the publication of the Form 1040 package, the IRS directed taxpayers to claim three deductions as follows:

- Taxpayers claiming a deduction for tuition and fees paid to a post-secondary institution were directed to report the deduction on Form 1040, line 35, “Domestic production activities deduction.” The domestic production activities deduction relates to manufacturing and bears no relation to post-secondary expenses.
- Educators claiming a deduction for out-of-pocket classroom expenses were directed to report the deduction on Form 1040, line 23, “Archer MSA deduction.” The Archer MSA deduction relates to medical savings accounts and bears no relation to expenses educators incur when they purchase items for use in their classrooms.
- Taxpayers claiming a deduction for state and local *sales* taxes were directed to report the deduction on Form 1040, Schedule A, line 5, “State and local *income* taxes” (emphasis added).

In each case, taxpayers were instructed to place a code on the line to distinguish the deduction they were claiming from the deduction for which the line was originally intended (*i.e.*, “ST” to claim the sales tax deduction; “T” to claim the tuition and fees deduction or “B” to claim both the domestic production activities and tuition and fees deductions; and “E” to claim the educator expenses deduction or “B” to claim both the Archer MSA and educator expenses deductions).<sup>21</sup>

Even leaving aside that taxpayers relying on the pre-printed Form 1040 package would not have known about these deductions, many taxpayers who knew about the availability of these deductions and claimed them found the instructions confusing and did not follow them properly. As discussed above, the IRS estimates that the percentage of taxpayers claiming the deductions for state and local taxes, educator expenses, and post-secondary tuition and fees dropped by 3.7 percent, 8.5 percent, and 14.2 percent, respectively, in 2006 as compared with 2005. Those percentage reductions reflect IRS’s best estimates after attempting to adjust for taxpayers who neglected to include the designated codes on the instruction lines. Separate IRS data that reflect the way taxpayers reported these deductions (*i.e.*, without attempting to adjust for taxpayers’ failure to include the designated codes) showed corresponding reductions of 24.5 percent, 35.9 percent, and 27.0 percent in the num-

<sup>20</sup> Tax Relief and Health Care Act, Pub. L. No. 109-432, 120 Stat. 2922 (2006).

<sup>21</sup> See IRS News Release IR-2007-03, IRS Plans Feb. 3 Start Date for Processing Extender Claims (Jan. 8, 2007). Where taxpayers claimed both the domestic production activities and tuition and fees deductions on the same line or the Archer MSA and educator expenses deductions on the same line, they were instructed to attach a breakdown showing the amounts claimed for each deduction.

ber of taxpayers claiming the deductions for state and local sales taxes, educator expenses, and post-secondary tuition and fees in 2006 as compared with 2005.<sup>22</sup> The need to resort to “workarounds” like this is confusing and burdensome to both taxpayers and the IRS.

**6. *Late-year changes reduce the impact of tax incentives.***

When Congress provides a tax credit or tax deduction, it is seeking to encourage taxpayers to undertake the activity that gives rise to the deduction. For example, the deduction for charitable contributions is designed to encourage taxpayers to make donations to charities. Similarly, as discussed above, the tax break for tuition and fees paid to post-secondary institutions is designed to encourage taxpayers to pursue higher education and the tax break given to teachers who incur out-of-pocket classroom expenses is designed to encourage teachers to furnish classroom supplies.

When Congress adds a tax benefit at the end of the year, taxpayers do not have much time to learn about the provision and act accordingly. As a consequence, the inducement effect of these provisions is substantially limited, partially undermining their purpose.

**7. *Taxpayers are deprived of the ability to engage in legitimate tax planning.***

As a matter of basic fairness, U.S. taxpayers are entitled to know what tax rules apply to them when they are making financial decisions. If a taxpayer is considering whether to make a large consumer purchase and lives in a state with a high sales tax rate, the taxpayer’s decision could be contingent on whether he or she may claim a sales tax deduction with respect to the sales tax paid on the purchase.

Similarly, taxpayers often are given the advice to accelerate deductions and defer income recognition to the extent legally permissible – but the advice is often different for taxpayers who may be subject to the AMT. Taxpayers are deprived of the ability to plan wisely when decisions about AMT exemption amounts are not made until the final weeks of the year.

**8. *When late-year changes increase taxes, taxpayers may be subject to unanticipated penalties for failure to pay sufficient estimated tax. When late-year changes reduce taxes, taxpayers may have experienced unnecessary financial hardship if they elected to have more tax withheld than was necessary.***

Taxpayers are generally expected to determine how much tax to have their employers withhold or how much estimated tax to pay based on their anticipated tax liabilities for the year. When significant changes are made during the latter portion of the year that have retroactive effect to the beginning of the year, taxpayers who initially planned their tax withholding or estimated tax payments correctly will suddenly find that they have overpaid or underpaid (depending on the direction of the changes).

<sup>22</sup> IRS Statistics of Income Division, *Tax Year 2006 Taxpayer Usage Study*, Report No. 16 (2007).



A cash-strapped taxpayer who overpays tax on the basis of prior law may experience an unnecessary burden. A taxpayer who underpays in reliance on prior law may be unfairly subject to a penalty for failure to pay sufficient estimated tax.<sup>23</sup> Neither result is fair to taxpayers.

**9. *The burdens associated with late-year changes have the potential to reduce filing and payment compliance.***

Over the last few years, considerable congressional and public attention has focused on the “tax gap” – the amount of tax that is due but goes unpaid. The IRS’s most recent estimate is that about 16 percent of tax due is not voluntarily and timely paid.<sup>24</sup>

The uncertainty and confusion created by late tax-law changes has the potential to reduce compliance. On one end of the compliance spectrum, most taxpayers comply fully or substantially with their tax obligations. On the other end, a relatively small number of taxpayers willfully violate the laws. In the middle, there is a segment of taxpayers that is inclined to comply but only if doing so is not overly burdensome. As it is, the IRS currently estimates that the average Form 1040-series taxpayer devotes 26.4 hours and spends \$207 to meet his or her tax-filing obligations.<sup>25</sup> Last-minute changes in the law, delays in the start of the filing season, and seemingly bizarre instructions like directing taxpayers to report college tuition expenses on a line labeled “Domestic production activities deduction” increase compliance burdens and are therefore likely to reduce compliance at the margins.

**10. *The burdens associated with late-year changes undermine public confidence in the fairness and competence of the government.***

U.S. persons have more contact with the IRS every year than with any other federal agency. In 2007, individual taxpayers filed approximately 135 million individual income tax returns.<sup>26</sup> In FY 2006, the most recent year for which full taxpayer assistance data is available, taxpayers visited the IRS website about 194 million times, had more than 32 million telephone conversations with IRS employees, and traveled to IRS walk-in sites for in-person assistance on more than six million occasions.<sup>27</sup>

For many taxpayers, tax filing is the only significant contact they have with the federal government during the year. As late-year changes exacerbate an already confusing and time-consuming compliance process and can have the effect of significantly altering the tax liabilities that taxpayers had expected to incur, there is a risk that public confidence in the fairness and competence of the federal government will be undermined.

<sup>23</sup> See IRC § 6654.

<sup>24</sup> See IRS News Release, IRS Updates Tax Gap Estimates (Feb. 14, 2006) and accompanying charts.

<sup>25</sup> IRS Form 1040 Instructions (2007), at 84.

<sup>26</sup> See IRS Filing Season Statistics (available at [www.irs.gov](http://www.irs.gov)).

<sup>27</sup> IRS Data Book, 2006, Table 19.



In effect, the Internal Revenue Code constitutes a complex set of rules that bind both the government and taxpayers. It is tempting to draw a baseball analogy and say that amending the tax code in December is like changing the rules of a baseball game in the bottom of the ninth inning. But that analogy doesn't go far enough. More accurately, changing the tax code in December and giving the changes retroactive effect to January 1st is like changing the rules of a baseball game in the ninth inning and making the new rules retroactive to the first inning.

To date, the impact of this practice is not as harsh as the analogy makes it sound because the changes have generally been taxpayer-favorable. But for the reasons described above, late-year changes to the tax code do have significant consequences, and the National Taxpayer Advocate believes taxpayers would be better off if late-year changes of this magnitude can generally be avoided.

***11. Last-minute changes in law increase the risk that IRS processing problems will arise during the filing season and that, as a consequence, taxpayers will be unable to file returns or the IRS will be unable to process returns properly.***

As described above, the IRS must do extensive work to prepare for the filing season, including programming multiple computer systems, printing forms, instructions and publications, coordinating with tax software providers, and providing up-to-date training to IRS employees who answer taxpayer questions as well as to VITA and TCE sites. When the IRS is required to re-do its preparations at the last minute to reflect changes in law, the likelihood of error increases. Potential programming problems raise especially significant risks, as returns can be improperly rejected or improperly processed.

The IRS normally runs extensive tests to ensure that all of its systems are working properly both on their own and interactively. When the IRS is forced to make extensive last-minute changes, however, it may face a difficult choice – it may be required to delay the filing season significantly or it may have to settle for less systems testing than it prefers in order to open the filing season as quickly as possible. To date, the IRS has managed to accommodate late changes in the law without running into significant processing problems. However, its luck is unlikely to hold indefinitely. The more often the IRS is asked to accommodate last-minute changes in the law, the greater the risk that something will go wrong.

***12. The extensive work IRS must perform to accommodate last-minute changes in law has an opportunity cost – it requires the IRS to pull employees off other priority work.***

It is a credit to the IRS that it has been nimble enough to implement late-year tax-law changes without undue problems in recent years. However, its success in this endeavor is not cost-free. When the IRS is required to essentially make its filing season preparations twice – once under the law as it exists for most of the year and again under laws adopted late in the year – its key information technology (IT) personnel and resources must be

diverted from other priority work. The IRS faces significant IT challenges, and the need to divert extra IT resources to the filing season detracts from its ability to make other much-needed IT improvements. Non-IT functions are also diverted from priority work as, for example, the IRS must devote resources to developing new forms and instructions for taxpayers, new guidance for software providers, and new training materials for tax-law assisters and for VITA and TCE sites.

### Recommendation

To ensure that members of Congress understand the filing-season impact of tax legislation, we recommend that the Treasury Department and the tax-writing committees create a formal process through which IRS estimates of the filing-season impact of significant tax legislation are transmitted to the tax-writing committees at several points during the year, perhaps on June 30, September 30, and monthly thereafter. The estimates should focus on legislation to extend expiring tax provisions.

MSP  
#2**Tax Consequences of Cancellation of Debt Income****Responsible Officials**

Richard J. Morgante, Commissioner, Wage and Investment Division

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division

**Definition of Problem**

When a borrower is unable to pay a debt and the creditor cancels some or all of it, the borrower may face a significant (and perhaps surprising) tax consequence — the amount of loan cancellation is generally treated as taxable income to the debtor.<sup>1</sup> To those without a tax background, the notion that canceled debt generally gives rise to taxable income may seem counterintuitive and unfair. However, the Internal Revenue Code (IRC) also provides that canceled debt will not be taxable in certain circumstances, including where a debt is discharged in bankruptcy, or to the extent that a taxpayer's liabilities exceed the taxpayer's assets.

In 2006, creditors issued to borrowers nearly two million Forms 1099-C, Cancellation of Debt, which are required when creditors write off all or a portion of a debt as uncollectible.<sup>2</sup> Common situations included defaults on automobile loans or credit card bills.<sup>3</sup> In recent months, the issue of loan defaults has attracted particular attention because of the subprime mortgage crisis, as many families have been unable to meet their payment obligations and have consequently lost their homes to foreclosure.

The tax treatment and reporting of canceled debt is complex and poses a significant challenge for affected taxpayers. A taxpayer who receives a Form 1099-C is likely to have a number of questions, including:

- Why does my inability to pay a debt cause me to have a tax liability?
- What should I do if I disagree with amounts reported by my lender on Form 1099-C?

<sup>1</sup> IRC § 61(a)(12) (stating that gross income includes "[i]ncome from discharge of indebtedness").

<sup>2</sup> IRS Document 6961, Table 2 (showing that the IRS received 1,942,694 Forms 1099-C in 2006 and projects it will receive 2,058,600 Forms 1099-C in 2007).

<sup>3</sup> Cancellation of indebtedness income can arise in other contexts as well. In testimony before the House Ways and Means Subcommittee on Oversight, for example, the National Taxpayer Advocate described several TAS cases involving a refund anticipation loan (RAL), where a taxpayer used the proceeds from the RAL to make a down payment on a more expensive vehicle than the taxpayer could afford, the taxpayer fell behind on his monthly payments, the dealer repossessed the vehicle, and the taxpayer ended up with cancellation of indebtedness income. *Fraud in Income Tax Return Preparation: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways & Means, 109<sup>th</sup> Cong. (2005)* (testimony of Nina E. Olson, National Taxpayer Advocate, Internal Revenue Service).

- What is the difference between a recourse loan and a nonrecourse loan, how do I determine which type of loan I have, and what is the effect of the distinction?
- How can I determine whether I qualify for the insolvency exception?
- If I do qualify for the insolvency exception, how should I report it on a tax return?
- What is “attribute reduction” and why do I need to worry about it?
- Why won’t the IRS or a Volunteer Income Tax Assistance (VITA) site help me prepare my tax return?

Based on our review, we are concerned that the IRS does not provide adequate guidance to assist taxpayers with cancellation of indebtedness income. In some cases, the lack of guidance may cause taxpayers to pay more tax than they owe. This section of the report highlights key areas of complexity and proposes steps the IRS can take to clarify and simplify the reporting rules for taxpayers.

## Analysis of Problem

### Background

When an individual or business borrows money, the loan proceeds do not constitute income to the borrower because the borrower assumes an obligation to repay the loan. If the borrower is relieved of all or part of the repayment obligation, however, the amount of the debt canceled generally must be included in the borrower’s gross income.<sup>4</sup>

There are certain circumstances in which canceled debt does not give rise to taxable cancellation of indebtedness income. Common exceptions include the following:<sup>5</sup>

- The debt is canceled in a title 11 bankruptcy case.<sup>6</sup>
- The taxpayer is insolvent at the time the debt is canceled.<sup>7</sup> The amount of canceled debt excludible from gross income is capped at the amount by which the taxpayer is insolvent.<sup>8</sup> Insolvency means the amount by which a person’s total debts exceed the fair market value of his total assets. So, for example, if a lender cancels a debt of \$20,000 and the taxpayer’s liabilities exceed his assets by \$15,000, the taxpayer may exclude \$15,000 from gross income but must still report gross income of \$5,000.

<sup>4</sup> IRC § 61(a)(12).

<sup>5</sup> In addition to the exceptions described in the text, there are two other circumstances in which canceled debt is excludible from gross income – where the discharged debt is qualified farm indebtedness and, in the case of a taxpayer other than a C corporation, where the discharged debt is qualified real property business indebtedness. Canceled debt also is not taxable to the debtor if the cancellation is intended as a gift.

<sup>6</sup> IRC § 108(a)(1)(A).

<sup>7</sup> IRC § 108(a)(1)(B).

<sup>8</sup> IRC § 108(a)(3).

- The taxpayer is not personally liable for the debt.<sup>9</sup> In general, canceled debt gives rise to taxable cancellation of indebtedness income only if the borrower is personally liable for it. A borrower is personally liable where the lender is entitled to pursue the borrower's other assets if the borrower defaults. This type of debt is referred to as "recourse" debt. If the terms of the loan agreement provide that the lender's only remedy in case of default is to repossess the property, the debt is referred to as "nonrecourse" debt. Cancellation of nonrecourse debt generally does not give rise to taxable cancellation of indebtedness income.

In December 2007, in response to widespread foreclosures resulting from subprime mortgages, Congress added a fourth exception that applies to debts canceled when a homeowner becomes unable to make payments on a loan secured by his "principal residence," up to a maximum of \$2 million. However, this relief provision is only temporary. It applies to debts canceled in 2007, 2008, and 2009.<sup>10</sup> It does not apply to debts canceled after 2009.

#### Problems with Forms 1099-C Issued by Lenders

The IRC generally requires any applicable financial entity or federal agency that cancels a debt of \$600 or more during a calendar year to file an information return.<sup>11</sup> The information return generally must be filed on Form 1099-C and provided to both the IRS and the person whose debt was canceled (*i.e.*, the debtor).<sup>12</sup> The Form 1099-C must be furnished to the debtor by January 31 of the year following the year in which the debt cancellation occurs.<sup>13</sup>

Many debtors first learn of their potential tax liability resulting from a canceled debt when they receive a Form 1099-C. Because the rules governing the taxation of canceled debts are complex and not particularly well explained, many taxpayers have trouble grasping them. As a result, some taxpayers probably pay more tax than they owe simply because they do not understand that they qualify for an exclusion.

Two issues relating to Forms 1099-C, in particular, constitute traps for the unwary.

<sup>9</sup> See Treas. Reg. § 1.1001-2(a)(1) & (c), Example (7). A taxpayer with canceled recourse debt who is claiming the bankruptcy or insolvency exception faces different reporting rules than a taxpayer with canceled nonrecourse debt. Canceled recourse debt gives rise to taxable cancellation of indebtedness income, so both the income and the exclusion must be reported on a tax return. Canceled nonrecourse debt does not give rise to taxable cancellation of indebtedness income, so there is no need for a taxpayer with cancellation of indebtedness income to report it as such. As discussed in more detail in the text below, however, the amount of canceled nonrecourse debt generally is included as part of the "amount realized" from the disposition of property.

<sup>10</sup> Mortgage Forgiveness Debt Relief Act, Pub. L. No. 110-142, § 2 (2007). In general, property will be considered the principal residence of the taxpayer if, during the five-year period ending on the date of the foreclosure (or the date of a loan modification that results in a reduction in loan principal) the taxpayer used the property as the taxpayer's principal residence for periods totaling at least two years.

<sup>11</sup> IRC § 6050P. By its terms, the applicable Treasury regulation requires that a Form 1099-C be filed if an "identifiable event," as described in Treas. Reg. § 1.6050P-1(b)(2), has occurred. While the definition of "identifiable event" generally describes a cancellation of indebtedness, a reader seeking a precise understanding of the scope of the requirement should refer to the regulation.

<sup>12</sup> Treas. Reg. § 1.6050P-1(a)(1).

<sup>13</sup> *Id.*

*1. There is often no single “correct” fair market value of property.*

There is more room for subjectivity about the amount of income required to be reported on Forms 1099-C than on most other 1099-series forms. On a Form 1099-INT, Interest Income, for example, a bank will very rarely err in reporting the amount of interest it paid a depositor on a savings account. The amount is clear-cut. By contrast, the amount of canceled debt reported on a Form 1099-C often depends on the lender’s subjective judgment about the fair market value of any property used as collateral and taken in satisfaction of the debt. The determination of fair market value is crucial because, by definition, the amount of any cancellation of indebtedness income equals the amount of the borrower’s outstanding debt reduced by the fair market value of the collateral at the time the debt is canceled.<sup>14</sup>

Fair market valuations of many assets are rarely clear-cut (*e.g.*, a car, a home, or a boat). In general, the starting point for assessing value is the price at which property actually sells. If a homeowner without stringent time constraints places his house on the market, for example, it is reasonable to assume the price at which he comes to terms with a buyer reflects the fair market value of the property at that time. If the seller is forced to complete a sale within a short period of time, however, the seller may accept an offer that falls well short of the property’s fair market value. If a lender forecloses on property and holds it for several months before selling it and market conditions change, the price at the time of sale may not be the same as the fair market value at the time the foreclosure occurred. Moreover, if a lender sells the property to a related party (*i.e.*, an affiliate), the sales price might bear no relation to the fair market value at all.

To illustrate, a recent New York Times article on the tax consequences of mortgage foreclosures described a family that lost its home when it could no longer make payments on its \$106,000 mortgage.<sup>15</sup> The lender, a leading national bank, “offered the two-bedroom house for sale on the courthouse steps. No bidders came forward. So [the bank] bought it for \$1,” the article said. The lender apparently issued a Form 1099-C to the homeowner that pegged the value of the home at \$1. On a \$106,000 mortgage, that meant the amount of canceled debt would have been reported at \$105,999. The article does not indicate whether the family received a Form 1099-C, but it does say that the family ultimately received a tax bill from the IRS for \$34,603.

The family hired a lawyer who tried, without success, to get the tax bill reversed. It was only after the New York Times reporter contacted the bank for comment that the bank filed a corrected Form 1099-C showing that no debt had been canceled. It turned out that the bank had resold the house to another bank for the exact amount of the mortgage – \$106,000 – several months later, and the purchasing bank, in turn, resold the house for \$140,000 within another month. The lending bank also had obtained an appraisal shortly before the foreclosure valuing the house at \$132,844.

<sup>14</sup> See Treas. Reg. § 1.1001-2(c), Example 8; Rev. Rul. 90-16, 1990-1 C.B. 12.

<sup>15</sup> Geraldine Fabrikant, *After the Pain of Foreclosure, A Big Tax Bill*, New York Times, Aug. 20, 2007, at A1.

In this case, it is clear that the bank would have been wrong to have originally reported the fair market value of the house at \$1. It appears the value could reasonably have been pegged at \$106,000 (the sale price), \$132,844 (the appraisal value), or \$140,000 (the price upon the resale that occurred within one month of the original sale). If there was a tax appraisal or an appraisal based on sales of comparable houses within the same geographic region, other values may have been supportable as well.

Similar issues arise for other types of property. If a person's car is repossessed, for example, there is likely to be a range of plausible values, including the actual resale price of the vehicle, comparable sales, and estimates provided by the Kelley Blue Book, Edmunds, and the National Automobile Dealers Association. These values can diverge by thousands of dollars.

Yet many taxpayers are probably unaware that the amount of cancellation of indebtedness income is a function of the property's fair market value and that fair market valuation of property can often be challenged. Even taxpayers who know this principle must still determine how to challenge the value.

The IRS advises taxpayers who disagree with any of the information reported on Form 1099-C to contact the issuer,<sup>16</sup> but this approach may not be productive. First, the taxpayer may not be able to locate a telephone number for the issuer. On many forms in the 1099 series (e.g., Form 1099-INT, Interest Income, Form 1099-DIV, Dividends and Distributions, or Form 1099-B, Proceeds From Broker and Barter Exchange Transactions), the IRS requires the issuer to include its telephone number. Yet for no valid policy reason that we can discern, the IRS does not require issuers of Forms 1099-C to include a telephone number.<sup>17</sup> Second, the issuer may not be in a position to determine the value of the property. Often, particularly in the case of homes, the original lender may package numerous loans together and sell them to investors. Thus, the issuer of a Form 1099-C may be a servicing agent that neither owns the property nor has access to information about the account beyond the amount due. Third, the amount of work an issuer must do to investigate a challenge to its fair market value assessment, consider and decide on alternative valuations, and correct a Form 1099-C is significant. Lenders may therefore be reluctant to commit the resources to doing this except in egregious cases. If the issuer declines to revise Form 1099-C, it may be burdensome for a taxpayer to persuade the IRS that the form is incorrect and that a different value should be used.

<sup>16</sup> IRS, *Questions and Answers on Home Foreclosure and Debt Cancellation*, Q&A 6, <http://www.irs.gov/newsroom/article/0,,id=174034,00.html> (last visited Nov. 6, 2007).

<sup>17</sup> Section 6050P(a)(3) of the IRC and corresponding Treasury regulations give the IRS authority to require issuers of Forms 1099-C to include their phone numbers. Section 6050P(a)(3) provides that issuers must include, in addition to certain specified information, "such other information as the Secretary may prescribe." Treas. Reg. § 1.6050P-1(a)(1)(v), in turn, provides that issuers must include, in addition to certain specified information, "[a]ny other information required by Form 1099-C or its instructions, or current revenue procedures." Under this authority, the IRS may include in its instructions a requirement that an issuer of Form 1099-C provide a telephone number on the form.

**2. *Taxable cancellation of indebtedness income does not arise upon the foreclosure or other disposition of property subject to a nonrecourse debt, yet Forms 1099-C do not distinguish between recourse debts and nonrecourse debts.***

As discussed above, a foreclosure or other disposition of a taxpayer's property does not give rise to cancellation of indebtedness income if the underlying debt is "nonrecourse." Instead, any nonrecourse debt discharged in the foreclosure or other disposition is treated as part of the amount realized from the disposition and may give rise to gain on the disposition.<sup>18</sup> A nonrecourse debt is a debt for which the lender's only remedy in case of default is to repossess the property that secures the debt. Although the foreclosure or other disposition of property subject to a nonrecourse debt does not give rise to cancellation of indebtedness income, there is no difference in the way canceled recourse debts and canceled nonrecourse debts are reported on Form 1099-C.<sup>19</sup> Many debtors do not understand the legal distinction, do not know which type of debt they have, and are not aware that the tax consequences differ.<sup>20</sup> As a result, it is likely that some taxpayers end up treating canceled nonrecourse debts as taxable cancellation of indebtedness income even where the cancelled debts do not give rise to cancellation of indebtedness income. Additional taxpayers will receive tax bills from the IRS because IRS's document-matching programs will process the canceled-debt amounts shown in box 2 of Form 1099-C.

**Taxpayer Challenges in Reporting Canceled Debts on Form 1040**

In general, taxpayers must report the canceled amount of a non-business debt on Form 1040, line 21 (Other income) and the canceled amount of a business debt on Form 1040, Schedule C or Schedule C-EZ (or on Form 1040, Schedule F, if the taxpayer is a farmer and the debt is farm debt).<sup>21</sup> A taxpayer required to show canceled debt income on a return is ineligible to file Form 1040A or Form 1040EZ, even if the debt is excludable.<sup>22</sup>

For taxpayers with canceled business debts, the instructions for Schedule C make no mention of cancellation of indebtedness income.<sup>23</sup> For taxpayers with canceled non-business

<sup>18</sup> See Treas. Reg. § 1.1001-2(a)(1) & (c), Example (7). However, any reduction in the principal balance of a nonrecourse debt that occurs outside the context of a foreclosure or other disposition of the property (e.g., as part of a loan modification, or "workout") generally gives rise to taxable cancellation of indebtedness income. Rev. Rul. 91-31, 1991-1 C.B. 19.

<sup>19</sup> By contrast, Form 1099-C contains a box labeled "Check for bankruptcy" to help taxpayers and the IRS determine quickly whether the bankruptcy exclusion applies.

<sup>20</sup> The terms of the loan agreement entered into by the borrower and the lender determine whether the loan is recourse (meaning the taxpayer is personally liable for the debt) or nonrecourse (meaning the taxpayer is not personally liable for the debt and the creditor's sole remedy in case of default is to repossess the property being financed or used as collateral). Thus, borrowers who are unsure should read the agreement. Alternatively, a borrower may contact the lender for assistance in making the determination.

<sup>21</sup> IRS Pub. 525, *Taxable and Nontaxable Income* at 18 (2006).

<sup>22</sup> IRS Form 1040A Instructions at 16 (2006).

<sup>23</sup> The instructions for Schedule F contain one paragraph on cancellation of indebtedness. See IRS Instructions for Schedule F at F-3 (2007). However, the instructions provide limited information, directing taxpayers to consult IRS Pub. 225, *Farmer's Tax Guide*, "to find out if you must include any cancellation of debt in income."



debts, the guidance is confusing, difficult to locate, and incomplete. The following are some of the reporting challenges that taxpayers with canceled debts face:

1. *IRS Form 1040 instructions imply that canceled debts must be included in gross income (and thus that they are taxable) and do not adequately describe the existence or scope of the exclusions.*

In the instruction booklet accompanying Form 1040, the IRS devotes the better part of a page to describing the types of income that should be included on, or excluded from, line 21 (Other income). The description contains separate lists of taxable income and nontaxable income. Canceled debts are included on the list of taxable income sources.

The instructions, in relevant part, simply state:

Examples of income to report on line 21 are:

\* \* \* \* \*

Canceled debts. These amounts may be shown in box 2 of Form 1099-C. See Pub. 525 or go to [www.irs.gov](http://www.irs.gov) and enter “canceled debt” or “foreclosure” in the search box.<sup>24</sup>

The instructions describing the types of income that must be included on line 21 make no mention that, under certain circumstances, some or all of the amount of canceled debt may be excluded from income.

Other IRS guidance mentions the possibility of exclusions but does not provide adequate detail. The only other reference to canceled debt in the Form 1040 instructions is made in a chart listing the various information-reporting forms a taxpayer may receive and showing where on Form 1040 to include the reported amounts. For Forms 1099-C, the chart directs taxpayers to report the amount from box 2 on “Form 1040, line 21, but first [to] see the instructions on Form 1099-C.”<sup>25</sup> So here, too, there is no mention of exceptions.

If a taxpayer takes the time to read the instructions to Form 1099-C, he will find a single paragraph that attempts to summarize the exceptions. The paragraph does not mention that canceled nonrecourse debt may be excluded. There is a sentence that instructs taxpayers: “[D]o not include canceled debts in your income to the extent you were insolvent.” However, the instructions neither explain what the term “insolvent” means nor provide a cross-reference telling taxpayers where to find an explanation.

Similarly, the Form 1040, line 21 instructions (quoted above) cross reference Publication 525, Taxable and Nontaxable Income. This publication includes a general

<sup>24</sup> IRS Form 1040 Instructions at 24 (2007).

<sup>25</sup> *Id.*

description of the tax treatment of canceled debts, which runs more than a page. But it, too, fails to explain what “insolvent” means.<sup>26</sup>

The brief blurb on insolvency in Publication 525 contains a cross-reference to Publication 908, Bankruptcy Tax Guide. Publication 908 correctly states: “You are insolvent when, and to the extent, your liabilities exceed the fair market value of your assets.”<sup>27</sup>

However, a taxpayer would only be likely to find this sentence if he or she already knew what to look for. Since the general description of income includible on Form 1040, line 21, makes no direct reference to exclusions, many taxpayers would stop at that point and assume the canceled debt reported in box 2 of Form 1099-C should be included in income, as the Form 1040 instructions indicate. Even a taxpayer who follows the cross-reference to Publication 525 could easily miss the insolvency exception, since it is mentioned only briefly near the end of the discussion and is not explained. Moreover, even the more detailed description in Publication 908 does not describe the scope of includible assets and liabilities, which remains a source of some contention and considerable confusion.

**2. *The definition of “assets” for purposes of computing the insolvency exception under section 108 of the Internal Revenue Code differs from prior judicial decisions, and IRS guidance on the scope of the term “assets” is often unclear.***

As described above, a taxpayer who is insolvent at the time a debt is canceled may exclude the canceled amount from gross income up to the amount of the insolvency. Insolvency is generally defined as the amount by which a person’s debts exceed the fair market value of his assets.<sup>28</sup>

Under a longstanding judicial doctrine, the term “assets” generally included only assets that were subject to the claims of creditors.<sup>29</sup> Thus, retirement assets and other assets beyond the reach of creditors under state law were excluded.

In 1980, Congress codified the current insolvency exception for canceled debt.<sup>30</sup> The IRS has interpreted the statute as requiring that all assets including retirement savings – not merely assets subject to the claims of creditors – be included within the definition of “assets.”<sup>31</sup> In 2001, the U.S. Tax Court considered a dispute involving the scope of the term “assets” and concluded that the taxpayers were required to include the value of an Alaska fishing permit in their assets for purposes of the insolvency exception, even though the permit was apparently an asset exempt from the claims of creditors under Alaska law. In

<sup>26</sup> IRS Pub. 525, *Taxable and Nontaxable Income* 19 (2006).

<sup>27</sup> IRS Pub. 908, *Bankruptcy Tax Guide* at 21 (1996).

<sup>28</sup> IRC § 108(d)(3).

<sup>29</sup> See, e.g., *Lakeland Grocery Co. v. Commissioner*, 36 B.T.A. 289 (1937); see also *Carlson v. Commissioner*, 116 T.C. 87 (2001) (discussing the evolution of the judicial doctrine).

<sup>30</sup> Bankruptcy Tax Act, Pub. L. No. 96-589, § 2(a), 94 Stat. 3389 (1980).

<sup>31</sup> IRS Serv. Ctr. Adv. 1998-039 (Apr. 1, 1998).

so doing, the Tax Court rejected the taxpayers' argument that assets beyond the reach of creditors generally may be excluded from the insolvency calculation.<sup>32</sup> However, very few decided cases have addressed whether assets exempt from creditor claims generally must be included in "assets" for purposes of the insolvency computation, and we have found no decided cases that address whether retirement assets, in particular, must be included. Therefore, while the IRS position on this point is clear, the treatment of these assets is not settled law from a judicial standpoint.

Perhaps because the IRS interpretation of the Bankruptcy Tax Act produces a different result than the judicial doctrine, the scope of includible "assets" for purposes of the insolvency computation is a source of confusion for practitioners as well as taxpayers. In addition to the dispute illustrated by the Tax Court case, for example, a recent USA Today article, citing a CPA who has written a book on resolving financial problems, stated that "[a]ssets are considered anything you own that can be attached by a creditor" and, "in most cases, retirement savings, such as 401(k) plans aren't [counted]."<sup>33</sup>

In many if not most cases, taxpayers who default on debts are insolvent. After all, debtors typically go into default when they lack the financial resources to pay their debts. Therefore, it is critical that taxpayers who receive Forms 1099-C be given more information about insolvency, particularly what it means and how it is computed.

In addition, retirement savings are the primary savings for most taxpayers. It is therefore crucial that taxpayers be advised whether retirement assets are considered assets for purposes of the insolvency computation. Because there is no description of insolvency in the Form 1040 instructions or Publication 525 and because the scope of covered "assets" in Publication 908 is not clearly described ("You are insolvent when, and to the extent that, your liabilities exceed the fair market value of your assets"), taxpayers do not have adequate guidance to prepare and support an insolvency claim.

**3. *IRS instructions do not explain clearly how a taxpayer entitled to exclude all or a portion of a canceled debt from gross income should report the exclusion on Form 1040.***

As discussed above, the Form 1040 instructions tell taxpayers with certain canceled debts to include on Form 1040, line 21, the amount the lender reports to them on Form 1099-C, box 2. However, the instructions do not tell taxpayers entitled to exclude all or a portion of that amount where to reflect the excludible portion on Form 1040. To arrive at correct taxable income and tax computations, the instructions could either direct the taxpayer to report the excludible amount on a subsequent line on the return or direct the taxpayer to subtract the excludible portion from the total canceled debt and place the net amount on line 21. However, the instructions do not address this point at all.

<sup>32</sup> *Carlson v. Comm'r*, 116 T.C. 87 (2001).

<sup>33</sup> Sandra Block, *Your Money: Beware Tax Bite After Losing Your Home*, USA Today, Sept. 25, 2007, at 3B.

In response to a TAS information request, the IRS wrote:

If all or a portion of the cancelled debt is excludable from income, then the net amount would generally be included on line 21 and a disclosure statement should be attached to the return explaining why the amount on line 21 of the Form 1040 is different than that reported on the information return the creditor provided to the IRS and to the debtor. If any amount of a canceled debt is excluded from income, Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness, should be filed. Form 8275, Disclosure Statement, may also be used and particularly, if additional explanation is warranted.<sup>34</sup>

This answer indicates that any amount of canceled debt excludible from gross income should be netted against the amount reported in box 2 of Form 1099-C when reported on line 21 of the taxpayer's Form 1040. It would be helpful to taxpayers if the Form 1040 instructions are revised to make this clear.<sup>35</sup>

**4. *The requirement that taxpayers excluding canceled debts file Form 982 is confusing to taxpayers, as the form is highly technical and seemingly does not apply to most taxpayers with non-business debts.***

Publication 908 states: "If a debtor excludes canceled debt from income because it is canceled in a bankruptcy case or during insolvency, he or she **must** use the excluded amount to reduce certain 'tax attributes.'"<sup>36</sup> Form 1099-C generally directs taxpayers who exclude any portion of a canceled debt from gross income to file Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment).

Form 982 is complex. Pursuant to Paperwork Reduction Act requirements, the IRS estimates that the amount of time it takes business taxpayers to complete the one-page form is ten hours and 43 minutes.<sup>37</sup> The technical level of the form is imposing. Among the items the form asks taxpayers to report are "qualified farm indebtedness," "qualified real property business indebtedness," "real property described in section 1221(a)(1)," "depreciable real property," "depreciable property," "net operating loss," "general business credit carryover," "minimum tax credit," "net capital loss," "nondepreciable and depreciable property," "passive activity loss and credit carryovers," and "foreign tax credit carryover to or from the year of the discharge."

It is hard to imagine that many taxpayers can figure out how to reduce their tax attributes without assistance from a tax professional. Fortunately, many taxpayers should not have to. Most individuals who are not engaged in a trade or business as sole proprietors are unlikely

<sup>34</sup> Small Business/Self-Employed (SB/SE) division response to TAS information request (Oct. 30, 2007).

<sup>35</sup> Presumably, taxpayers with canceled business debts would report them on Schedule C, line 6, and net any amounts excludible from gross income on the same line, but the instructions do not make that clear.

<sup>36</sup> IRS Pub. 908, *Bankruptcy Tax Guide 22* (1996) (emphasis in original).

<sup>37</sup> IRS Form 1099-C, *Cancellation of Debt* (2007) (Instructions for Debtor).

to have any tax attributes to reduce, and for those who do, the tax attributes likely will be limited to net capital losses and foreign tax credit carryovers. However, neither Form 982 nor its instructions make that point clear. As a consequence, many non-business taxpayers are required to complete an extraordinarily complex form and will assume – logically but erroneously – that the end result is that they will be required to reduce tax attributes.

The IRS could substantially simplify the task of completing the form for non-business taxpayers by clarifying the instructions. Just as with the earned income tax credit (EITC), the instructions could provide a “pre-Form 982” worksheet in which basic questions are asked (*e.g.*, “Are you engaged in a trade or business as a sole proprietor?”). Depending on the answers, the taxpayer could be directed fill in zeros on all lines, or all applicable lines, of Form 982.

#### 5. *IRS Form 1040 instructions do not make the proper treatment of canceled nonrecourse debt clear.*

As described above, Form 1099-C does not distinguish between recourse debt and non-recourse debt even though canceled recourse debt generally is taxable as cancellation of indebtedness income while canceled nonrecourse debt, although included in the determination of gain or loss on foreclosure or other disposition, generally is not taxable as cancellation of indebtedness income.<sup>38</sup> For taxpayers, the failure of Form 1099-C to distinguish between recourse debt and nonrecourse debt is compounded by the absence of any discussion of the subject in the Form 1040 instructions.

Even Publication 525, which the Form 1040 instructions reference, does not expressly state that canceled nonrecourse debt does not constitute taxable cancellation of indebtedness income. Publication 525 merely states that “[i]f you are not personally liable for a mortgage (nonrecourse debt), and you are relieved of the mortgage when you dispose of the property (such as through foreclosure or repossession), that relief is included in the amount you realize.”<sup>39</sup> While that statement is accurate, it does not clarify that the relief is not includable as cancellation of indebtedness income.

As a consequence, we are concerned that some taxpayers end up including canceled nonrecourse debts in their gross income as cancellation of indebtedness income and paying tax on those amounts where they are not required to do so.<sup>40</sup>

<sup>38</sup> This general rule is subject to an exception. The amount of canceled nonrecourse debt generally is taxable as cancellation of indebtedness income where the borrower retains the property but the amount of nonrecourse debt is reduced (*e.g.*, as part of a loan modification, or “workout”). See Rev. Rul. 91-31, 1991-1 C.B. 19.

<sup>39</sup> IRS Pub. 525, *Taxable and Nontaxable Income* 18 (2006).

<sup>40</sup> We note, however, that when a lender forecloses on a loan or repossesses property securing a nonrecourse loan, the amount of canceled nonrecourse debt is treated as part of the proceeds (*i.e.*, “amount realized”) that the property owner receives in exchange for the property. IRC § 7701(g). A foreclosure or repossession of property is treated as a sale or exchange on which a taxpayer may recognize gain or loss. Therefore, a nonrecourse debtor may recognize more gain on a sale as a result of the foreclosure or repossession than would a recourse debtor. Treas. Reg. § 1.1001-2(a)(1) & (c), Example 7. This is another point that could be more clearly explained to taxpayers.

**6. *Taxpayers with canceled debts are unable to obtain assistance in preparing their returns from the IRS or at VITA/TCE sites.***

As the above discussion demonstrates, the tax treatment of canceled debt is complex. This is of particular concern with respect to the insolvency exception because many taxpayers with canceled debts are likely to qualify for the insolvency exception. In a series of “Questions and Answers on Home Foreclosure and Debt Cancellation” posted on its website, the IRS states: “Insolvency can be fairly complex to determine and the assistance of a tax professional is recommended if you believe you qualify for this exception.”<sup>41</sup>

Yet – presumably because of the complexity of the rules – the IRS has designated the tax treatment of canceled debt a subject that is “out of scope” for tax return preparation assistance at Volunteer Income Tax Assistance (VITA) sites, Tax Counseling for the Elderly (TCE) sites, and the IRS’s own Taxpayer Assistance Centers (TACs).<sup>42</sup> This designation places taxpayers in a no-win situation. On the one hand, the IRS has published very little guidance on the computation of insolvency and is telling taxpayers that they would be well advised to seek assistance in preparing their returns. On the other hand, the IRS is making free return preparation assistance unavailable to these taxpayers – taxpayers who have just defaulted on one or more debts and probably do not have the funds to hire a preparer.<sup>43</sup>

As a consequence of the complexity of the law, the financial difficulties these taxpayers are experiencing, and the IRS’s decision to declare canceled-debt issues “out of scope” for return preparation assistance at free sites, it is likely that taxpayers with canceled debts will make unnecessary and costly errors.

**7. *Because some taxpayers learn about canceled debt income for the first time when they receive a notice from the IRS, the information the IRS provides should be more comprehensive.***

Taxpayers experiencing financial difficulties are disproportionately likely to have moved. That is particularly so, of course, where a taxpayer has lost his home due to foreclosure.<sup>44</sup> Therefore, some taxpayers with canceled debts never receive Form 1099-C from the lender. Without a Form 1099-C, taxpayers are likely to file their tax returns without addressing the canceled-debt issue and will become aware of the rules governing canceled debts for the first time when they receive a notice from the IRS proposing to adjust their tax liability.

<sup>41</sup> See <http://www.irs.gov/newsroom/article/0,,id=174034,00.html> (last visited Nov. 6, 2007).

<sup>42</sup> SB/SE response to TAS information request (Oct. 30, 2007). We share the IRS’s view that cancellation-of-debt issues may be too complex for VITA and TCE sites, but we believe the IRS is capable of preparing returns involving these issues at the TACs. In fact, the IRS already has developed a training module that includes 5 hours of instruction on cancellation-of-debt issues. *Id.* (citing Module 6677, Advanced Individual Tax Law Training, Module C, Reporting Asset Transactions); see also Most Serious Problem: *Service at Taxpayer Assistance Centers, infra.*

<sup>43</sup> Even apart from declining to provide return preparation, the IRS has designated general questions about the tax treatment of canceled debts “out-of-scope” at its walk-in sites. However, the IRS will answer general questions about canceled debts on its toll-free assistance number (800-829-1040). SB/SE response to TAS information request (Oct. 30, 2007).

<sup>44</sup> Some taxpayers register with the U.S. Postal Service, but many do not. In addition, some taxpayers may have no fixed address after losing a home; a taxpayer may move from one friend’s or relative’s home to another, or may even spend time in a homeless shelter or other transient locale.

The notice the IRS currently sends to taxpayers with apparent unreported canceled-debt income contains one paragraph describing what the taxpayer should do “if you [the taxpayer] claimed insolvency.”<sup>45</sup> This statement assumes the taxpayer understands the meaning of the word “insolvency,” which often will not be the case, and implies that the procedures for demonstrating insolvency described in the paragraph may not be applicable if the taxpayer did not claim insolvency on his original tax return – which he perhaps failed to do because he did not receive Form 1099-C and did not know he was required to include canceled-debt income. More fundamentally, the paragraph provides limited explanation of the rules governing canceled debts and the potentially applicable exceptions, including those other than insolvency.

In the absence of adequate information, many taxpayers are less likely to respond or to respond appropriately, and some taxpayers are likely to end up with tax assessments in cases where no liability should exist.

## Conclusion

The taxation of canceled debts is a complex subject, primarily because it involves the interaction of numerous sets of rules and concepts – the general IRC § 61(a)(12) rule that canceled debts are includible in income, the IRC § 108(a) exceptions, the special rule for nonrecourse debts, ambiguity in perception regarding the meaning of the term “assets” for purposes of computing the insolvency exception, rules governing the sale or disposition of property, rules governing tax attributes and their ordering, information reporting requirements, and nontax issues like property valuation.<sup>46</sup>

The IRS addresses each of these subjects in varying levels of detail in the course of the numerous publications and other guidance cited in this discussion. However, the IRS has not consolidated guidance on canceled debts into a single publication. We believe the complexity of this subject combined with the relatively large number of affected taxpayers (as noted above, nearly two million Forms 1099-C were issued last year) demonstrates the need for the IRS to develop such a publication.

<sup>45</sup> When the IRS’s “automated underreporter” (AUR) system – a computer system designed to detect underreporting – generates a CP-2000 notice on the basis of a Form 1099-C, it includes two paragraphs (jointly numbered as paragraph 72) that describe the requirement to include canceled debts in income and the substantiation the taxpayer should provide “if you [the taxpayer] claimed insolvency.”

<sup>46</sup> The above discussion is by no means intended to provide an exhaustive description of the rules governing the tax treatment of canceled debts. There are others. To cite two:

- If a financial institution offers a discount for the early payment of a mortgage loan, the amount of the discount is considered canceled debt that ordinarily must be included in gross income.
- If any interest is canceled along with a debt, whether the canceled interest must be included in gross income depends on whether the interest would be deductible by the taxpayer if it had been paid. Thus, interest on a canceled personal debt generally must be included in gross income, while interest on a canceled business debt generally may be excluded.

IRS Pub. 525, *Taxable and Nontaxable Income* 18 (2006). Significantly, home mortgage interest – even though it may appear to be “personal” interest rather than “business” interest – generally is deductible under IRC § 163(h)(3), subject to certain limitations.



Primarily in response to the need for guidance for homeowners who have lost their homes to mortgage foreclosures (since resolved by legislation) and secondarily in response to TAS's information requests, the IRS has now assembled significant information on this subject in one place that, without significant additional work, could be converted into a publication. We believe such a publication would substantially benefit taxpayers with canceled debts as well as practitioners who represent them.

We also think it would be helpful for the IRS to require issuers of Forms 1099-C to include a telephone number at which taxpayers may contact them with questions or to discuss valuation issues; require issuers of Forms 1099-C to indicate whether a canceled debt is recourse or nonrecourse; provide more specific guidance concerning the computation of insolvency; clarify that persons claiming exclusions from canceled-debt income should net the excludible amount against the amount reported on Form 1099-C when completing Form 1040, line 21; revise the instructions for Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment), to make them clearer for individual taxpayers who, despite the title of the form, have neither tax attributes to reduce nor basis to adjust; include more detailed information (a "stuffer") concerning the tax treatment of canceled debts when notices to taxpayers are issued through the Automated Underreporter (AUR) program proposing adjustments to tax; and treat the subject of canceled debt, including the insolvency exception, "in scope" for purposes of both answering general questions and preparing tax returns at the TACs.

## IRS Comments

The IRS appreciates the National Taxpayer Advocate's attention to this emerging economic issue, and agrees that the tax treatment and reporting of cancelled debt is complex and poses challenges for affected taxpayers. Many debtors first learn of their potential tax liability resulting from a canceled debt when they receive a Form 1099-C and a taxpayer who receives a Form 1099-C is likely to have a number of questions. In order to address the proliferation of questions arising from this emerging economic issue, the IRS has posted a series of "questions and answers" on its web site. However, the IRS also agrees that more clarity is needed and is taking action to address many of the concerns cited by the National Taxpayer Advocate.

### Problems with Forms 1099-C Issued by Lenders

The National Taxpayer Advocate suggests several modifications to Form 1099-C to facilitate accurate reporting of cancellation of debt income:

- Add a telephone number for taxpayers to contact the issuer with questions or to discuss valuation issues.
- Require issuers to indicate on Form 1099-C whether the debt is recourse or nonrecourse.



The IRS agrees that the suggested changes may help a taxpayer to accurately determine and report cancellation of debt income. The IRS plans to obtain additional stakeholder input on this issue and will discuss the proposed changes with the IRS Information Reporting Program Advisory Committee (IRPAC) to assess feasibility, the potential impact on the reporting community, and whether a forms change is the most appropriate solution. The IRS plans to raise these suggestions at the January 2008 IRPAC meeting in Washington, DC.

### **Taxpayer Challenges in Reporting Cancelled Debt**

1. *IRS Form 1040 instructions imply that canceled debts must be included in gross income (and thus that they are taxable) and do not adequately describe the existence or scope of the exclusions.*

The IRS agrees more clarity is needed and will make the following changes to the 2008 Form 1040 instructions:

- In the chart on page 8 listing the Form 1099-C, the IRS will revise the chart to refer taxpayers to Publication 525, Taxable and Nontaxable Income. To address the National Taxpayer Advocate's concern that Publications 525 includes a general description of the tax treatment of canceled debt, but no explanation of what "insolvent" means, the IRS is expanding Publication 525 for 2008, to include a definition of "insolvent" based on the definition in the Internal Revenue Code section 108(d)(3).
  - In the Form 1040 instructions for line 21 on page 24, the IRS will add a sentence to the item on Canceled debts. The new sentence will read: "In some cases, canceled debts are nontaxable".
2. *The definition of "assets" for purposes of computing the insolvency exception under section 108 of the Internal Revenue Code differs from prior judicial decisions, and IRS guidance on the scope of the term "assets" is often unclear.*

The IRS will continue to follow its current position that all assets are included under § 108(d)(3). Unless regulations are issued to the contrary, the IRS does not currently plan to add a new definition of assets that excludes assets not subject to the claims of creditors.

3. *IRS instructions do not explain clearly how a taxpayer entitled to exclude all or a portion of a canceled debt from gross income should report the exclusion on Form 1040.*

The IRS agrees more clarity is needed and will explain how to report the exclusion in Publication 525 for 2008, including an example of a taxpayer who can exclude part, but not all, of the canceled debt.

**4. *The requirement that taxpayers excluding canceled debts file Form 982 is confusing to taxpayers, as the form is highly technical and seemingly does not apply to most taxpayers with non-business debts.***

The IRS agrees that Form 982 is complex, but is concerned that adding a worksheet to Form 982, as suggested for non-business taxpayers, would be more complicated and time consuming than completing the form. However, for the attribute “basis of property,” the IRS will clarify the types and the reduction order within this attribute. The IRS will also include the following tip: “Tip. Review the seven listed attributes to see if any apply to you. Attribute 5, basis of property, is a common attribute that applies to real, personal, or other property whether that property is used in a business, for investment, or for non-business purposes (such as a residence you own or your personal car or boat).”

**5. *IRS Form 1040 instructions do not make the proper treatment of canceled nonrecourse debt clear.***

While the proper treatment of canceled nonrecourse debt is beyond the scope of the Form 1040 instructions, the 2008 Form 1040 instructions will be revised to refer taxpayers to Publication 525. In addition, the IRS will make the following changes to Publication 525 for 2008:

- The definition of “nonrecourse” will be expanded to clarify the proper treatment of canceled nonrecourse debt.
- A sentence will be added clarifying that the taxpayer does not report the mortgage relief as other income on line 21 of Form 1040 or Form 1040NR.
- A definition of “insolvent” will be included based on the definition in IRC 108(d) (3).

**6. *Taxpayers with canceled debts are unable to obtain assistance in preparing their returns from the IRS or at VITA/TCE sites.***

As the National Taxpayer Advocate’s report indicates, because of the complexity of the rules, the tax treatment of canceled debt is a subject that is “out of scope” for tax return preparation assistance at VITA sites, TCE sites, and the TACs. However, taxpayers requesting assistance at the TACs on the tax treatment of canceled debt will be provided a fact sheet that will assist them in answering frequently asked questions and direct them to other options, such as [irs.gov](http://irs.gov) and the toll-free phone lines.

**7. *Because some taxpayers learn about canceled debt income for the first time when they receive a notice from the IRS, the information the IRS provides should be more comprehensive.***

The National Taxpayer Advocate’s report states taxpayers experiencing financial difficulties are disproportionately likely to have moved, particularly when a taxpayer has lost his home due to foreclosure. The National Taxpayer Advocate’s report further states that the notice the IRS currently sends to taxpayers with apparent unreported canceled debt income

contains one paragraph describing what the taxpayer should do “if you” [the taxpayer] claimed insolvency.

The AUR process requires tax examiners to consider several factors prior to pursuing unreported Cancellation of Debt income. These include the fair market value on Form 1099-C, Cancellation of Debt, IDRS (Integrated Data Retrieval System) bankruptcy indicators and Form 982, Reduction of Tax Attributes due to Discharge of Indebtedness. Information from Form 982 is reviewed to determine the allowable reduction of tax attributes reported by the taxpayer.

However, the IRS has already begun the process of expanding the language in Paragraph 72 of the CP-2000 notice. The expanded language will refer taxpayers to Publication 908, Bankruptcy Tax Guide, for further information on debt cancellations and exclusions. The expanded language will also provide taxpayers with additional guidance and information regarding foreclosures. The IRS expects the changes to be made by the end of calendar year 2007 affecting CP2000s for the tax year 2006 inventory. The IRS will also review Publication 1593 (Automated Underreporter) regarding cancellation of debt issues and consider additional updates.

### Taxpayer Advocate Service Comments

The National Taxpayer Advocate appreciates the IRS’s thoughtful response and the significant attention the IRS has devoted to this issue in recent months. We believe the IRS’s plans to address this issue, as described in its response, should help taxpayers. However, we believe the IRS can do more to provide taxpayers with clearer guidance.

We reiterate our view that this is a significant issue because of the large number of taxpayers affected and the complexity of the relevant concepts and rules. As we noted above, the IRS receives about *two million* Forms 1099-C from issuers each year, largely relating to canceled debts like defaults on car loans or credit card bills. As for complexity, taxpayers or practitioners trying to determine the proper way to report cancellation of indebtedness income must navigate a bewildering array of tax concepts and rules as well as IRS forms, instructions, and publications.

As we noted in our original report, relevant concepts and rules include:

- The general IRC § 61(a)(12) rule that canceled debts are includible in income;
- The exceptions provided under IRC § 108(a);
- The rule that the cancellation of nonrecourse debts generally does not give rise to cancellation of indebtedness income;
- Ambiguity in perception regarding the scope of the term “assets” for purposes of computing insolvency;

- Rules governing the sale or disposition of property;
- Rules governing tax attributes and their ordering;
- Information reporting requirements; and
- Nontax issues like property valuation.

Relevant IRS forms, instructions and publications include:

- IRS Form 1099-C, Cancellation of Debt, and the accompanying instructions;
- IRS Form 1040, U.S. Individual Income Tax Return, and the accompanying instructions;
- IRS Form 1040, Schedule C, Profit or Loss From Business (Sole Proprietorship), and the accompanying instructions;
- IRS Form 1040, Schedule F, Profit or Loss From Farming, and the accompanying instructions;
- IRS Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment), and the accompanying instructions;
- Possibly Form 8275, Disclosure Statement, and the accompanying instructions;
- IRS Publication 525, Taxable and Nontaxable Income;
- IRS Publication 908, Bankruptcy Tax Guide; and
- IRS Publication 225, Farmer's Tax Guide.

Even this multitude of forms and publications does not cover all significant issues. For example, existing instructions do not address the tricky issues that can arise in valuing property, including the significance of value in determining the amount of cancellation of indebtedness income, the fact that a single item of property may have a range of reasonable values, and the importance of a taxpayer's paying attention to the value reported by the lender and challenging it if he believes it is wrong.

To help taxpayers fight through this maze, the National Taxpayer Advocate urges the IRS to do more to provide assistance in person, by phone, and by publication.

**Face-to-Face Assistance.** As research conducted for the Taxpayer Assistance Blueprint (TAB) demonstrated, there is a segment of taxpayers that *requires* face-to-face assistance. There is an even larger segment of taxpayers that *prefers* face-to-face assistance. For that reason, we believe the IRS should be prepared to assist taxpayers with cancellation of indebtedness questions at its TACs in two ways. First, the IRS should prepare tax returns for taxpayers otherwise eligible for IRS assistance — and not refuse to prepare a return for a taxpayer simply because the taxpayer received a Form 1099-C. Second, the IRS should ensure that taxpayers with general questions about cancellation of indebtedness income can obtain answers at the TACs. It is understandable that the IRS declares complex issues

“out-of-scope” when they affect small numbers of taxpayers or high-income taxpayers who are likely to obtain professional assistance. However, the National Taxpayer Advocate believes the IRS has a responsibility to provide full assistance on issues that affect a large number of taxpayers who are, by the nature of the issue, disproportionately likely to be experiencing financial challenges and therefore be unable to hire a preparer.

**Telephone Assistance.** A taxpayer with questions about the tax treatment of a canceled debt may call the IRS’s main taxpayer assistance telephone number (1-800-829-1040). To improve the quality of service, we encourage the IRS to provide specialized training on cancellation of indebtedness issues to a unit of telephone assisters and then to establish a separate “gate” for taxpayers with questions about canceled debts to enable them to reach that unit (*e.g.*, “press 1 if you have questions about a Form 1099-C that you received”). The IRS provides “gates” for other significant issues and often establishes “gates” for taxpayers affected by disasters (*e.g.*, 9/11 and Hurricane Katrina). Given the large number of taxpayers who receive Forms 1099-C and the likelihood that additional questions will arise this year concerning the tax consequences of mortgage foreclosures, we believe creating a unit of IRS telephone assisters with specialized training in answering questions about canceled debts is warranted.

**Written Guidance.** As the bulleted list above shows, a taxpayer with questions about the tax treatment of cancellation of indebtedness income must read through up to six sets of forms and instructions and up to three publications. Taxpayers and practitioners need and deserve one-stop shopping on this issue. We strongly recommend that the IRS develop a publication on the tax treatment and reporting of cancellation of indebtedness income that consolidates all relevant information in one place.

A few additional points:

First, the IRS states that it will consult with its Information Reporting Program Advisory Committee (IRPAC) regarding our suggestion that IRS require issuers of Form 1099-C to include a phone number and to indicate whether a canceled debt was recourse or nonrecourse. While we applaud the IRS for seeking stakeholder input on these and other issues, we believe it is important for the IRS to consult with the Taxpayer Advocacy Panel (TAP) and representatives of the IRS’s Low Income Taxpayer Clinic (LITC) program as well to obtain a more complete perspective. IRPAC includes representatives of financial institutions that must do 1099-C reporting and can speak to its burdens, which is an important consideration, but the TAP and especially LITC representatives reflect the perspective of taxpayers and practitioners and speak to the burdens that could be alleviated with more complete reporting, which is also an important consideration.

Second, when the IRS issues automated underreporter (AUR) notices to taxpayers in response to Forms 1099-C, the notices should include information about the availability of the LITCs and TAS to assist taxpayers who need help understanding the issue and responding to the notice. This is important for a number of reasons. To cite one, we have noted

that nonrecourse debts generally do not give rise to taxable income. However, the IRS does not know whether a Form 1099-C it receives relates to a recourse debt or a nonrecourse debt. It therefore will send the same notice to taxpayers with both types of loans. If a taxpayer is confused by the notice and does not respond, the IRS ultimately will assess tax — even if the taxpayer had a nonrecourse loan and does not owe tax. Similarly, taxpayers are not alerted to the significance of the issuer's valuation of property, and the amount of income reported by the issuer may be incorrect. Again, a taxpayer who does not know what to look for or how to challenge the proposed adjustment will ultimately receive an assessment. The LITCs and TAS can help such taxpayers to avoid this outcome.

Third, the IRS appears to have misinterpreted our suggestion that the meaning of the terms “assets” and “liabilities” be more clearly explained for purposes of determining the existence and amount of insolvency. We did not intend to suggest that the IRS change its legal position. To the contrary, we simply suggest that the IRS explain the implications of its position more clearly. To help ensure that taxpayers list all relevant assets and all relevant liabilities, the IRS should provide a list of the most common types of each along with a statement that the list is not all inclusive. For example, the IRS could specifically state that the term “assets” includes the fair market value of real property, automobiles, stocks and bonds, bank accounts, and all retirement assets. It could state that the term “liabilities” includes mortgages, automobile loans, student loans, and credit card debt. A list of this nature would serve as a tickler and increase the likelihood that taxpayers and practitioners will compute insolvency correctly.

Fourth, we continue to believe that many non-business taxpayers and some practitioners find IRS Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment), bewildering and are unable to complete it properly. The “Tip” the IRS proposes to add, while helpful, will not do enough to mitigate confusion. As discussed above, the IRS estimates that the amount of time it takes business taxpayers to fill out the one-page form is ten hours and 43 minutes. Among the items the form asks taxpayers to report are “qualified farm indebtedness,” “qualified real property business indebtedness,” “real property described in section 1221(a)(1),” “depreciable real property,” “depreciable property,” “net operating loss,” “general business credit carryover,” “minimum tax credit,” “net capital loss,” “nondepreciable and depreciable property,” “passive activity loss and credit carryovers,” and “foreign tax credit carryover to or from the year of the discharge.”

Taxpayers instructed to complete this form are often overwhelmed. Most non-business taxpayers need only indicate the reason for the claimed exclusion on line 1 and the amount of the claimed exclusion on line 2 and may leave the rest of the form blank. The IRS could save taxpayers thousands of hours if the instructions (and the publication we are recommending) make this point clear. One approach would be to begin by asking several questions to help the taxpayer determine whether or not the other lines of the form apply and, if so, which ones.

## Recommendations

The National Taxpayer Advocate recommends the IRS take the following steps:

1. The IRS should designate the tax treatment of canceled debts as “in scope” for purposes of preparing tax returns at the TACs.
2. The IRS should designate the tax treatment of canceled debts as “in scope” for purposes of answering general questions at the TACs.
3. The IRS should provide specialized training on cancellation of indebtedness issues to a unit of telephone assisters and then “gate” taxpayer calls on these issues to those assisters.
4. The IRS should develop a publication that specifically addresses the tax consequences of canceled debts that a taxpayer who receives a Form 1099-C will face. Answers to some of the questions addressed in this discussion can be found piecemeal in various IRS publications, but it is unlikely that a taxpayer or even many practitioners will have the time and ability to ferret out the answers, and some of the questions currently are not answered in any publication.
5. The IRS should require issuers of Form 1099-C to include a telephone number on the form. The IRS already requires issuers of other forms in the 1099 series, including Form 1099-INT reporting interest income and Form 1099-DIV reporting dividend income, to include their telephone numbers on the form. When a debt cancellation has occurred, the likelihood that a disagreement about Form 1099 reporting is greater and the relationship between the issuer and the taxpayer generally will have terminated, making it less likely that the taxpayer would continue to receive other documents from the issuer including a telephone number.
6. The IRS should explore the feasibility of requiring issuers of Form 1099-C to indicate whether debt forgiveness relates to a recourse loan or a nonrecourse loan. In light of the significantly different tax consequences, it would be helpful both for taxpayers in determining their tax liabilities and reporting requirements and for the IRS in determining whether a taxpayer has under-reported income to know the type of debt at issue.
7. The IRS should provide more specific guidance to assist taxpayers in computing insolvency. The explanation should clearly state the IRS’s view, which is currently that insolvency means the amount by which a taxpayer’s aggregate liabilities exceed his aggregate assets. The guidance should identify the most common types of assets and the most common types of liabilities to provide taxpayers and practitioners with a clearer understanding of what must be included in the calculation.
8. The IRS should make clear in the Form 1040 instructions that individuals should net the amount of canceled debt eligible for exclusion against the amount of canceled

debt reported on Form 1099-C when reporting the canceled debt amount includible in income on line 21 of Form 1040.

9. The IRS should revise the instructions for Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*, to make them clearer for individual taxpayers who, despite the title of the form, have neither tax attributes to reduce nor basis to adjust. In our view, the steps the IRS states that it plans to take are inadequate to address the confusion that Form 982 creates. We continue to believe that an initial set of questions or worksheet along the lines we described above would help taxpayers determine whether they must complete this complex form in detail or may simply check a box on line 1 to indicate the basis of the claimed exclusion and list the amount of the claimed exclusion on line 2.
10. When the IRS issues AUR notices to taxpayers in response to Forms 1099-C, the IRS should include more information (perhaps a “stuffer”) explaining the tax treatment of canceled debt and the various exceptions in detail. If the IRS creates a publication on canceled debt issues, the publication could serve as the stuffer.
11. When IRS issues automated AUR notices to taxpayers in response to Forms 1099-C, the notices should include information about the availability of Low Income Taxpayer Clinics and TAS to assist taxpayers who need help understanding the issue and responding to the notice.



MSP  
#3**The Cash Economy****Responsible Officials**

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division  
Richard J. Morgante, Commissioner, Wage and Investment Division

**Definition of Problem**

The “tax gap” – the amount of tax that is not voluntarily and timely reported and paid – which stands at \$345 billion per year, remains a serious problem.<sup>1</sup> Households that pay their taxes have to pay an average surtax of about \$2,680 per year to pick up the tab for those that do not.<sup>2</sup> The tax gap can also erode the level of confidence that taxpayers have in government. It increases both the need for examination and collection actions and the danger of possible overreaching by the IRS, which may further erode confidence in government and produce a vicious cycle of increased noncompliance and increased enforcement.

Underreported income from the “cash economy” – taxable income from legal activities that is not subject to information reporting or withholding – is probably the single largest component of the tax gap, likely accounting for over \$100 billion per year.<sup>3</sup> The significance of the compliance problem in the cash economy is not surprising since research shows that taxpayers report well over 90 percent of the types of income that are reported to the IRS by third parties, but less than 50 percent of the types of income that are not.<sup>4</sup> The cash economy may also contribute to noncompliance with filing and payment requirements. Cash economy transactions are difficult to quantify, however, because they are, by definition, unreported.<sup>5</sup>

<sup>1</sup> The gross tax gap is the amount of tax that is imposed by law for a given tax year, but not voluntarily and timely paid. The net tax gap is the portion of the gross tax gap that remains uncollected after taking into account late payments and IRS enforcement actions for a given tax year. The 2004 IRS National Research Program study estimates the 2001 gross tax gap at \$345 billion and the net tax gap at \$290 billion. IRS, *Tax Gap Map for Year 2001* (Feb. 2007), available at [http://www.irs.gov/pub/irs-utl/tax\\_gap\\_update\\_070212.pdf](http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf). These figures do not include unpaid tax on income from illegal activities.

<sup>2</sup> If we divide the estimated 2001 net tax gap of \$290 billion by an estimated 108,209,000 U.S. households we see that each household was effectively assessed an average “surtax” of about \$2,680 to subsidize noncompliance. U.S. Census Bureau, Population Division (data as of Mar. 2001).

<sup>3</sup> See IRS News Release, *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006) (accompanying charts), available at <http://www.irs.gov/newsroom/article/0,,id=154496,00.html>. Underreporting makes up about 83 percent of the tax gap (\$285 billion of the \$345 billion gap). Underreporting of business income by individuals – from sole proprietors, rents and royalties, and passthrough entities – accounted for about \$109 billion. *Id.* Associated underreporting of self-employment taxes by unincorporated businesses accounts for another \$39 billion. *Id.*

<sup>4</sup> See IRS News Release, *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006) (accompanying charts). Moreover, the Government Accountability Office found only one quarter of sole proprietors’ receipts were reported to the IRS on a Form 1099-MISC, *Miscellaneous Income*. Government Accountability Office, GAO-07-1014, *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance* 17 (July 2007), available at <http://www.gao.gov/new.items/d071014.pdf>.

<sup>5</sup> Of course the IRS can measure underpayment amounts with certainty, but it might not be able to determine whether the debtor participates in the cash economy.

Since the overall compliance rate has remained around 85 percent for decades, it may not be reasonable to expect the IRS to significantly improve overall compliance without imposing unacceptable burdens on taxpayers.<sup>6</sup> However, a goal of significantly raising compliance in the cash economy from below 50 percent might be reasonable, especially since a relatively small number of taxpayers account for most of the problem.<sup>7</sup> This discussion summarizes the National Taxpayer Advocate's administrative recommendations for addressing noncompliance in the cash economy, which are described in greater detail in Volume II of this report.<sup>8</sup>

## Analysis of the Problem

### Background

We use the term “cash economy” to mean taxable income from legal activities that is not reported to the IRS by third parties.<sup>9</sup> While this is the type of income most likely to be unreported by any taxpayer, it is most often earned by unincorporated businesses.<sup>10</sup>

The cash economy is growing. The percentage of all income subject to third party information reporting fell from 91.3 percent in 1980 to 81.6 percent in 2000.<sup>11</sup> Moreover, the IRS expects the number of individual returns from small business or self-employed taxpayers to grow by about 33 percent between 2006 and 2014, while the number of individual returns from other taxpayers is expected to decline by about 2 percent over the same period.<sup>12</sup>

The IRS's existing compliance tools are less effective in addressing noncompliance in the cash economy than other types of noncompliance. The IRS obviously cannot match the amount of income reported by third parties to amounts reported on an income tax return because cash economy transactions are not subject to information reporting.

<sup>6</sup> IRS, *Reducing the Federal Tax Gap, A Report on Improving Voluntary Compliance 2* (Aug. 2, 2007), available at [http://www.irs.gov/pub/irs-news/tax\\_gap\\_report\\_final\\_080207\\_linked.pdf](http://www.irs.gov/pub/irs-news/tax_gap_report_final_080207_linked.pdf). The latest estimate is 83.7 percent for TY 2001. *Id.* at 18.

<sup>7</sup> The Government Accountability Office recently found that 10 percent of sole proprietors with understated taxes account for 61 percent of the total tax liability. Government Accountability Office, GAO-07-1014, *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance* 15 (July 2007).

<sup>8</sup> A Comprehensive Strategy for Addressing the Cash Economy, Vol. II, *infra*. For a summary of the National Taxpayer Advocate's legislative recommendations, see Key Legislative Recommendation: Measures to Address Noncompliance in the Cash Economy, *infra*.

<sup>9</sup> There is no universally agreed-upon definition of the term “cash economy.” For a definition similar to the one used in this report, see *Bridging the Tax Gap: Hearing Before the S. Comm. on Finance*, 108th Cong. 21 (July 21, 2004) (statement of Professor Joseph L. Bankman defining the cash economy as “legal business transactions conducted in cash (or checks) that are not subject to withholding or third-party information reporting... your gardener, the family that owns the corner restaurant. Anyone that is getting cash or checks that is not subject to third-party reporting.”).

<sup>10</sup> See IRS News Release, *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006) (accompanying charts).

<sup>11</sup> Kim Bloomquist, *Trends as Changes in Variance: The Case of Tax Noncompliance*, presented at the 2003 IRS Research Conference (June 2003) (citing growth in capital gains, partnership, and small business income).

<sup>12</sup> Office of Research, Research, Analysis and Statistics, Document 6292, *Fiscal Year Return Projections for the United States, 2007-2014* (Sept. 2007), available at <http://www.irs.gov/pub/irs-soi/d6292.pdf>. Total individual returns are projected to increase by 11,828,232 (from 133,917,068 to 145,745,300), but this increase is entirely attributable to a 13,256,446 increase (from 40,052,154 to 53,308,600) in individual returns from self-employed and small business taxpayers. *Id.* If we subtract the projected increase in business returns from the projected increase in other individual returns, we find that other returns are expected to decline by 1,428,214 (11,828,232 - 13,256,446 = -1,428,214).

Because business activity in the cash economy is difficult to detect, it may also contribute to noncompliance with filing and payment requirements. Over three-quarters of the individual income tax underpayment gap is associated with individuals who have business income.<sup>13</sup> In some cases, noncompliance in the cash economy may result when taxpayers cannot pay what they owe and the IRS offers no reasonable payment alternatives.<sup>14</sup>

In recent years, the National Taxpayer Advocate has proposed a number of legislative and administrative steps to address the portion of the tax gap attributable to the cash economy.<sup>15</sup> Her administrative recommendations are briefly summarized below.<sup>16</sup>

### Recommendations

#### 1. *Establish a Cash Economy Program Office to coordinate IRS efforts to improve compliance in the cash economy.*

The IRS should create a cash economy program office to coordinate research, outreach, service, and enforcement initiatives aimed at improving compliance among cash economy participants.<sup>17</sup> Such an office should measure its success based on the impact of IRS initiatives on compliance by cash economy participants.<sup>18</sup> This office would bring accountability and focus to the IRS's dispersed efforts.

#### 2. *Develop a strategic plan for providing services, education, and outreach to small businesses.*

The IRS should develop a strategic plan for providing services, education, and outreach to small businesses. This strategy should be modeled on the Taxpayer Assistance Blueprint

<sup>13</sup> IRS, *Reducing the Federal Tax Gap, A Report on Improving Voluntary Compliance* 15 (Aug. 2, 2007), available at [http://www.irs.gov/pub/irs-news/tax\\_gap\\_report\\_final\\_080207\\_linked.pdf](http://www.irs.gov/pub/irs-news/tax_gap_report_final_080207_linked.pdf).

<sup>14</sup> See National Taxpayer Advocate 2006 Annual Report to Congress 83 (Most Serious Problem: IRS Collection Payment Alternatives); Most Serious Problem: Non-Filer Program, *infra*; Most Serious Problem: Offer in Compromise, *infra*.

<sup>15</sup> See, e.g., *A Comprehensive Strategy for Addressing the Cash Economy*, Vol. II, *infra*; National Taxpayer Advocate 2005 Annual Report to Congress 55 (Most Serious Problem: The Cash Economy); National Taxpayer Advocate 2005 Annual Report to Congress 381 (Key Legislative Recommendation: Measures to Reduce Noncompliance in The Cash Economy); Testimony of Nina E. Olson, National Taxpayer Advocate, Before the Senate Committee on Finance, The Tax Gap and Tax Shelters (July 21, 2004).

<sup>16</sup> For a summary of the National Taxpayer Advocate's legislative recommendations, see Key Legislative Recommendation, *Measures to Address Noncompliance in the Cash Economy*, *infra*. For a more detailed discussion of both legislative and administrative recommendations, see *A Comprehensive Strategy for Addressing the Cash Economy*, Vol. II, *infra*.

<sup>17</sup> In her 2005 Annual Report to Congress, the National Taxpayer Advocate recommended creating a Cash Economy Program Office. The IRS acknowledged that a well-coordinated strategy among various IRS offices might successfully improve compliance in the cash economy, but it was premature to create a program office until the results of the National Research Program (NRP) data became available. National Taxpayer Advocate 2005 Annual Report to Congress 73 (IRS response). The National Taxpayer Advocate believes that NRP tax gap estimates, which suggest significant noncompliance exists in the cash economy, and IRS projections of significant growth in the self-employed sector, justify creating a program office devoted to addressing noncompliance in the cash economy.

<sup>18</sup> TIGTA and GAO both generally agree that such measures would help the IRS reduce the tax gap. See, e.g., Government Accountability Office, GAO-06-208T, *Multiple Strategies, Better Compliance Data, and Long-Term Goals Are Needed to Improve Taxpayer Compliance* (Oct. 26, 2005); Written Statement of Russell George, Treasury Inspector General for Tax Administration, *Hearing Before the Senate Committee on Appropriations Subcommittee on Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies, On the Internal Revenue Service's Fiscal Year 2006 Budget Request* (Apr. 7, 2005).

(TAB), a multi-year plan for providing services to individual taxpayers to help them meet their tax obligations.<sup>19</sup> Like the TAB, this plan should be based on research.

Research may reveal that some small business taxpayers need face-to-face education, such as workshops. Although such education can be resource intensive, the IRS can leverage its resources by first using research to identify common small business errors that significantly contribute to the tax gap as well as those taxpayers who are most likely to make such errors and most likely to respond to workshops rather than other types of outreach.<sup>20</sup> In other words, the IRS can use research to narrowly target its outreach and education efforts.<sup>21</sup>

### 3. *Research and test the effectiveness of a targeted education campaign to improve attitudes about tax compliance.*

The IRS should research and test a targeted education campaign to promote compliance by changing attitudes and social norms among specific populations.<sup>22</sup> The research would identify subsections of the cash economy in which such an education campaign might be effective and then test the campaign. For example, for those small business taxpayers who do not trust the government, the campaign might emphasize the privacy of taxpayer information.

The IRS should leverage its limited resources by encouraging non-IRS educators to help. It should update, expand, and promote educational modules that it has already developed to make it easy for teachers to educate students about how to comply with business tax obligations.<sup>23</sup> The IRS should provide instructors, such as those teaching business administration classes in high schools, adult education programs, and community colleges, with whatever they need to easily incorporate basic tax compliance into their classes, especially in areas identified by research as needing additional education.<sup>24</sup>

<sup>19</sup> IRS Pub. 4579, *The 2007 Taxpayer Assistance Blueprint – Phase 2* (Apr. 2007).

<sup>20</sup> The Government Accountability Office recently found that 10 percent of sole proprietors with understated taxes account for 61 percent of the total tax liability. Government Accountability Office, GAO-07-1014, *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance* 15 (July 2007). The IRS may be able to identify subsets of this group for whom face-to-face education would be efficient.

<sup>21</sup> A cross-functional team, which included representatives from the Taxpayer Advocate Service, the Wage and Investment Operating Division, and Governmental Liaison and Disclosure, recently outlined a research and outreach plan for business taxpayers, which the IRS could use as a starting point. Memorandum for Director, Communications Liaison and Disclosure, from Task Force to Enhance Small Business Outreach, *Enhancing Outreach and Education to Small Business Taxpayers* (Sept. 4, 2007) (making nine recommendations to enhance current education and outreach opportunities).

<sup>22</sup> See National Taxpayer Advocate 2005 Annual Report to Congress 55 (Most Serious Problem: The Cash Economy). See also, Marjorie E. Kornhauser, *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*; National Taxpayer Advocate 2007 Annual Report to Congress, Vol. II, *infra* (recommending the IRS implement long and short term educational and media programs to encourage voluntary compliance that incorporate the findings of behavioral research).

<sup>23</sup> The IRS has already developed a number of modules which it could modify for this purpose. See, e.g., [http://www.irs.gov/app/understandingTaxes/jsp/s\\_student\\_lessons.jsp](http://www.irs.gov/app/understandingTaxes/jsp/s_student_lessons.jsp).

<sup>24</sup> The Taxpayer Advocate Service recently partnered with the IRS to develop an electronic toolkit that explains basic tax laws and procedures. The toolkit, titled “Taxes: What You Need to Know – Responsibilities & Benefits,” focuses on topics of interest to low income or limited English proficiency (LEP) taxpayers, and those with disabilities. The toolkit is online at [www.tax-toolkit.com](http://www.tax-toolkit.com) and is also available on DVD and as an IRS publication. The IRS could make similar modules with topics of interest to students in high school and college business classes. It should seek input from educators to see what teaching aids would be most helpful.

**4. Conduct research to identify tax rules that often confuse taxpayers, and provide simplifying guidance.**

The IRS should conduct research to identify administrative guidance, such as regulations, revenue procedures, and even form changes, which could make it easier for taxpayers to comply.<sup>25</sup> IRS researchers should seek input from internal and external stakeholders, including representatives from the small business community. Although the IRS Office of Chief Counsel regularly requests input from stakeholders in formulating its “priority guidance list,” more focused efforts might be more effective in identifying guidance that could make it easier for taxpayers to comply.<sup>26</sup>

**5. Create an “income” database to help identify underreporting and improve audit efficiency.**

The IRS should combine all of the gross receipts information that it receives from third parties into a single database. For example, the database could include income reported on Forms 1099, and possibly other sources of income information, such as state sales tax data and currency transaction reports such as Form 8300 (Report of Cash Payments Over \$10,000 Received in a Trade or Business), which businesses use to report the receipt of cash payments over \$10,000.<sup>27</sup> The IRS should use the income database to detect potential underreporting of income as well as nonfilers. It should also make the database available to auditors to improve audit efficiency.

**6. Obtain more state and local receipts-related data, match it against income reported on federal income tax returns, and use it to improve audit efficiency.**

The IRS should obtain more receipts-related information from state and local government agencies.<sup>28</sup> The IRS should start with traditional sources of receipt reporting such as state income and sales tax reporting, but should also consider other types of state and local filings, which require taxpayers to report receipts or a range of receipts, such as professional

<sup>25</sup> By making it “easier” we mean both reducing recordkeeping and reporting burdens and making the rules less confusing.

<sup>26</sup> Under current procedures, in determining whether to include an item on the priority guidance list, the IRS considers: (1) Whether the recommended guidance is consistent with the Code and Congressional intent; (2) Whether the recommended guidance promotes sound tax administration; (3) Whether taxpayers can easily understand and apply the recommended guidance; (4) Whether the IRS can administer the recommended guidance on a uniform basis; and (5) Whether the recommended guidance reduces controversy or lessens the burden on taxpayers or the IRS. IRM 32.1.1.4.3 (Aug. 11, 2004).

<sup>27</sup> The IRS should also study whether other currency reporting sources included in the Currency and Banking Retrieval System should be added to the income database. Other documents in the Currency and Banking Retrieval System include Currency Transaction Reports, Casino Currency Transaction Reports, and Foreign Money Instrument Reports. IRM 4.26.4 (Nov. 17, 2006). According to press accounts, the IRS has begun “reviewing databases (for example, Form 1099 filings) to look for inconsistencies in taxpayer reporting information, and the Cash Bank Reporting System, in which the IRS will review cash reports to see if there are any patterns resembling payrolls.” Kristen A. Parillo, *IRS Focusing On Worker Classification, Data Mining To Narrow Tax Gap*, 2007 TNT 191-7 (Oct. 2, 2007).

<sup>28</sup> The National Taxpayer Advocate made a similar recommendation in her 2005 Annual Report to Congress. See National Taxpayer Advocate 2005 Annual Report to Congress 55, 69 (Most Serious Problem: The Cash Economy). The IRS has made some progress in obtaining more agreements to obtain state data. See, e.g., National Taxpayer Advocate 2005 Annual Report to Congress 55, 62 (describing the IRS’s state sales tax matching project). However, it has generally been focusing more on obtaining sales tax audit reports rather than sales tax data. See IRS Seeking Increased Taxpayer Data Sharing With States, 2007 TNT 177-4 (Sept. 12, 2007). It is also seeking to obtain lists of filers from states so that it can identify taxpayers who file with the state but not the federal government. See, e.g., IRS, *Reducing the Federal Tax Gap, A Report on Improving Voluntary Compliance* 89 (Aug. 2, 2007).

licenses, business professional and occupational tax filings, and contractor licenses.<sup>29</sup> By adding this data to the income database and matching it against income reported on returns, the IRS could identify potential underreporting of income and nonfilers and improve audit efficiency.<sup>30</sup>

### 7. *Revise Form 1040, Schedule C to break out income not reported on information returns.*<sup>31</sup>

Sole proprietors report their business income by attaching Schedule C (Profit or Loss From Business) to Form 1040 (Individual Income Tax Return). Adding a line to Schedule C so that taxpayers separately report (1) the amount of income reported on Forms 1099 and (2) other income not reported on Forms 1099 could improve both voluntary compliance and audit selection and efficiency.

This change would encourage taxpayers to report income even if it is not subject to information reporting. It would also allow the IRS to match the income reported on Schedule C with income reported on Forms 1099 more easily.

### 8. *Revise business income tax return forms to highlight information reporting requirements.*<sup>32</sup>

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

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

These two questions would alert uninformed taxpayers of their reporting obligations and suggest to them that the IRS may enforce information reporting compliance. Payments reported to the IRS on information returns are much more likely to be reported on the payee's income tax return.<sup>33</sup> Thus, increased information reporting compliance would cause contractors (payees) to report more of their income.

<sup>29</sup> In addition, the IRS should consider getting lists of license holders, even if the state or locality does not ask for receipts information in connection with the license. For licenses that help taxpayers generate income, such as liquor licenses, contractor licenses, cosmetology licenses, real estate licenses, taxi medallions, and street vending licenses, appraiser licenses, and other professional licenses, the IRS could use these lists to identify potential nonfilers.

<sup>30</sup> An IRS study in Iowa found 2,607 instances over a three-year period where the gross sales reported to the state exceeded the gross receipts reported to IRS by \$100,000 or more and 304 cases where the difference was greater than \$1 million. IRS, Small Business/Self-Employed Division Research, Project No. BKN0048, *Matching State of Iowa Sales Tax Data Against Gross Receipts Reported to IRS* (Feb. 2007).

<sup>31</sup> The National Taxpayer Advocate made a similar recommendation in her 2005 Annual Report to Congress. See National Taxpayer Advocate 2005 Annual Report to Congress 55, 67 (Most Serious Problem: The Cash Economy).

<sup>32</sup> See *Id.* at 68.

<sup>33</sup> See IRS News Release, *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006) (accompanying charts).



**9. *Create a preparer database that tracks errors on client returns and use it for targeted outreach and, if outreach fails, possibly even audit selection.***

The IRS should create a preparer database containing the number of returns prepared and how often client returns contain various types of errors.<sup>34</sup> At least for those preparers who sign a sufficient number of returns, the database would allow the IRS to identify those who make frequent errors or may be encouraging taxpayers to underreport income.<sup>35</sup> Those preparers may have a significant effect on tax compliance.<sup>36</sup> The IRS should generate a compliance “score” for each preparer and send one or more notices to those preparers who make the most frequent errors, identifying the types of errors they are making and offering additional education. In cases where the notices fail to prompt the preparer to prepare returns with fewer errors, the IRS should also study whether it is feasible to select returns for audit based, in part, on the preparer’s score.

If taxpayers believe they may have a greater chance of being audited if they use a sloppy or unethical preparer, many will seek out preparers who have a reputation as being meticulous, conservative, and ethical. This might help reduce the pressure on preparers and other advisors to recommend return positions for which there may be little, if any, legal support. Market forces might reward conservative and ethical preparers, while providing an additional market-driven incentive for all preparers to shy away from such overly aggressive or unethical positions.<sup>37</sup>

<sup>34</sup> The IRS should not use the database to identify preparers who recommend positions with which it disagrees, but that have sufficient legal support. To address this concern, the IRS database should not reflect an “error” on a return if the IRS identified the adjustment as resulting from an area of legal uncertainty or if the IRS’s proposed adjustment is disputed and finally determined to be wrong by Appeals or a court. When the IRS makes adjustments that result from an area of legal uncertainty, auditors are supposed to document such uncertainty by entering a reason code (code 21) on existing IRS computer systems. IRM Exhibit 4.10.16-1 (Apr. 1, 2007). Some auditors will fail to correctly identify areas of legal uncertainty and some taxpayers will fail to dispute proposed adjustments for reasons unrelated to the merits of the initial return position. However, these significant safeguards should help address the concern, especially since only a relatively large number of “errors” listed in the preparer database would trigger action by the IRS, as discussed below. If these safeguards are insufficient, TAS can work with the IRS to identify additional safeguards.

<sup>35</sup> About 62 percent of all returns were prepared by a paid tax preparer in 2005, up from about 58 percent in 2000. IRS, *Tax Year 2006 Taxpayer Usage Study*, Rpt. No. 15 (Aug. 24, 2007), available at <http://www.irs.gov/taxstats/article/0,,id=96629,00.html>; IRS, *Tax Year 2002 Taxpayer Usage Study*, Rpt. No. 14 (Aug. 30, 2002). Since untrained and unscrupulous preparers may harm taxpayers, the National Taxpayer Advocate previously proposed that the IRS establish minimum levels of competency for return preparation and develop a federal system to register, test, and certify unenrolled return preparers. See, e.g., National Taxpayer Advocate 2002 Annual Report to Congress 216 (Key Legislative Recommendation: Regulation of Federal Tax Return Preparers); National Taxpayer Advocate 2006 Annual Report to Congress 197 (Most Serious Problem: Oversight of Unenrolled Return Preparers).

<sup>36</sup> A study conducted for the IRS found 98 percent of the respondents (taxpayers who were offered electronic filing but declined) said they trusted their preparer completely or very much. Russell Marketing Research, Pub. 4350, *Findings from One-On-One efile Research Among Taxpayers and Preparers* 24 (June 2004).

<sup>37</sup> See Gene Steuerle, *Restoring Professionalism to the Professions*, 115 Tax Notes 495 (Apr. 30, 2007). We recognize that this initiative might cause some preparers to stop signing returns. However, the IRS could address such a reaction by outreach to small businesses advising them to watch out for preparers who are not willing to stand behind their work by signing the return.

**10. *Develop a specialized audit program to detect the omission of gross receipts.***

The IRS should develop a specialized audit program to detect the omission of gross receipts. The focus on gross receipts should allow the unit, over time, to become more efficient, especially if it has access to an income database, as described above.<sup>38</sup> Additional IRS activity in this area could also have a significant “ripple” effect on compliance by other taxpayers as they learn that the IRS is increasingly able to detect unreported receipts.

**11. *Research the most effective use of IRS audit resources after taking into account the direct and indirect effects of IRS activities on tax revenue.***<sup>39</sup>

The IRS should research the most effective use of its audit resources after taking into account the direct and indirect effects of IRS activities on tax revenue. Audits directly help the IRS recover unpaid tax revenues from the taxpayer for the period(s) under examination. However, economists estimate the indirect effects of an audit on voluntary compliance provide further revenue gains. Two of the more prominent studies in this area suggest the indirect revenue gains are between 6 and 12 times the amount of any proposed audit adjustment.<sup>40</sup> However, not all audits have the same effect on compliance. The IRS needs more and better research on how best to use limited audit resources to improve compliance in the cash economy. For example:

- Should the IRS use more correspondence examinations or face-to-face examinations in cash economy industries? Does the answer depend on the industry?
- To have the greatest impact, should audits be clustered to any extent either geographically or within industries, so as to generate maximum publicity and possibly change community norms, or should they be more spread out?
- Do audits have an even greater “ripple” effect on compliance when coupled with outreach and education targeting unaudited members of the same community?

<sup>38</sup> The Government Accountability Office recently found that ten percent of sole proprietors with understated taxes account for 61 percent of the total tax liability and that 39 percent of sole proprietors made an error on the gross income line of Schedule C. Government Accountability Office, GAO-07-1014, *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance* 10, 15 (July 2007). Thus, such audits could be productive if properly targeted.

<sup>39</sup> The National Taxpayer Advocate made a similar recommendation in her 2005 Annual Report to Congress. See National Taxpayer Advocate 2005 Annual Report to Congress 55, 66 (Most Serious Problem: The Cash Economy).

<sup>40</sup> Alan H. Plumley, Pub. 1916, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness* 35-36 (Oct. 1996); Jeffrey A. Dubin, Michael J. Graetz & Louis L. Wilde, *The Effect of Audit Rates on the Federal Individual Income Tax, 1977-1986*, 43 Nat. Tax J. 395, 405 (1990).



### 12. *Make payment compliance easier by sending out estimated tax payment reminders to businesses that have been late in the past.*<sup>41</sup>

The IRS should send notices to taxpayers to remind them when estimated payments are due, at least for taxpayers who have made late (or missed) payments in the last few years. Most other creditors send customers a bill to remind them when a payment is due and offer the option of paying by automatic monthly (or even bi-weekly) withdrawals from the customer's bank account free of charge. The IRS's reminders should encourage taxpayers to use the Electronic Federal Tax Payment System (EFTPS), a free service, to make estimated tax payments electronically or by phone and to schedule them in advance, just like automatic payments to a mortgage lender or utility.<sup>42</sup>

Many businesses inadvertently fall behind on their estimated tax payments.<sup>43</sup> Taxpayers who want to comply with their estimated tax payment obligations sometimes fail because the process of estimating income, remembering odd payment dates, and saving enough money each quarter is cumbersome, especially for self-employed taxpayers who are juggling many different duties and have many competing demands on both time and funds.<sup>44</sup> According to IRS research, taxpayers who owe a balance upon filing their returns are more likely to understate their tax liability than other taxpayers.<sup>45</sup> Moreover, more than 20 percent of such taxpayers with a balance due fail to pay it in full.<sup>46</sup> Thus, if these notices help taxpayers remember to make timely estimated tax payments they are likely to increase both reporting and payment compliance.

<sup>41</sup> The National Taxpayer Advocate made a similar recommendation in her 2005 Annual Report to Congress. See National Taxpayer Advocate 2005 Annual Report to Congress 55, 72 (Most Serious Problem: The Cash Economy). Moreover, both the Government Accountability Office (GAO) and the Treasury Inspector General for Tax Administration (TIGTA) have previously recommended that the IRS test a soft notice program to improve estimated tax payment compliance. See General Accounting Office, GAO/GGD-99-18, *Billions In Self-Employment Tax Are Owed* 8 (Feb. 1999) and Treasury Inspector General for Tax Administration, Ref. No. 2004-30-040, *While Progress Toward Earlier Intervention With Delinquent Taxpayers Has Been Made, Action Is Needed to Prevent Noncompliance With Estimated Tax Payment Requirements* 19 (Feb. 2004) (recommending that IRS implement a soft notice for estimated tax payments and noting that although IRS planned to implement GAO's soft notice recommendation, it delayed and then canceled the planned implementation).

<sup>42</sup> The reminders could also mention Electronic Funds Withdrawal (EFW), which also allows taxpayers to pre-authorize up to four estimated tax payments from a checking or savings account when they e-file their returns. See, e.g., <http://www.irs.gov/efile/article/0,,id=101317,00.html>. EFW should allow taxpayers to pre-authorize monthly payments so that estimated tax payments are more regularly, just like other bills.

<sup>43</sup> A telephone survey found that approximately two-thirds of taxpayers with a balance due prior to filing their return did not plan to owe a balance upon filing. See Wage and Investment Division, Research Group 5, Project No. 5-03-06-2-028N, *Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters* 7 (Jan. 16, 2004), citing W&I Customer Research Group 5, *Causes and Potential Treatments for Underwithholding and Insufficient Estimated Payments* (2000).

<sup>44</sup> Estimated tax payments are due on the following oddly-spaced dates: April 15, June 15, September 15 and January 15. IRC § 6654(c)(2); Pub. 505, *Tax Withholding and Estimated Tax Payments*, 22 (Feb. 2007). These dates do not consistently coincide with calendar quarters, and some taxpayers do not believe the dates make sense. See Treasury Inspector General for Tax Administration, Ref. No. 2004-30-040, *While Progress Toward Earlier Intervention With Delinquent Taxpayers Has Been Made, Action Is Needed to Prevent Noncompliance With Estimated Tax Payment Requirements* 19 (Feb. 2004).

<sup>45</sup> Wage and Investment Division, Research Group 5, Project No. 5-03-06-2-028N, *Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters*, 7 (Jan. 16, 2004).

<sup>46</sup> *Id.*

### 13. Encourage taxpayers to pay estimated taxes electronically using the Electronic Federal Tax Payment System (EFTPS).<sup>47</sup>

The IRS should encourage taxpayers to pay estimated taxes electronically using EFTPS by waiving the penalty for one prior failure to make sufficient estimated tax payments for new enrollees. EFTPS makes it easy to pay estimated taxes and schedule future estimated tax payments. As noted above, any increase in estimated tax payment compliance is likely to increase both reporting and payment compliance. In 2004, the IRS encouraged taxpayers who pay depository taxes, such as employment taxes, to enroll in EFTPS by waiving one prior failure to deposit penalty for new enrollees.<sup>48</sup> In FY 2007, the IRS received about 71 percent of all employment tax payments (and about 97 percent of all employment tax dollars) through EFTPS.<sup>49</sup> A similar incentive would help encourage taxpayers to use EFTPS for estimated tax payments and promote both reporting and payment compliance.

### 14. Revise IRS collection policies to offer a reasonable payment alternative to all taxpayers who cannot fully pay what they owe.

The IRS should revise its collection policies to offer a reasonable payment alternative to all taxpayers who cannot fully pay what they owe. Under current policies, many taxpayers and IRS employees no longer view the IRS's offer in compromise program as a viable collection alternative.<sup>50</sup> Moreover, the IRS needs to look for opportunities to use its authority to enter into installment agreements with taxpayers, especially those who do not qualify for "streamlined" installment agreements under current rules (*e.g.*, because the delinquency has been allowed to age and exceeds \$25,000 or cannot be paid within 5 years).<sup>51</sup> When the IRS does not enter into an offer or installment agreement, it typically leaves the taxpayer in limbo by classifying his or her account as "currently not collectible" or placing it in the collection "queue," where it may sit unresolved for an extended period.<sup>52</sup> Such built-in

<sup>47</sup> The National Taxpayer Advocate made a similar recommendation in her 2005 Annual Report to Congress. See National Taxpayer Advocate 2005 Annual Report to Congress 55, 67 (Most Serious Problem: The Cash Economy).

<sup>48</sup> IRS News Release, *IRS Offers Penalty Refund for EFTPS Enrollment* (May 24, 2004); IRS Pub. 4048, *EFTPS: Special IRS Penalty Refund Offer* (Nov. 2006). The IRS discontinued the abatement program at the end of 2006. IRS Headliner Volume 184, *IRS to End EFTPS FTD Penalty Refund Offer* (Nov. 9, 2006).

<sup>49</sup> In contrast, the IRS received about one percent of all estimated tax payments (and about one percent of all estimated tax dollars) through EFTPS in fiscal year 2007. W&I, Client Account Services, Response to TAS information request (Oct. 10, 2007).

<sup>50</sup> See Most Serious Problem, Offer In Compromise, *infra/supra*.

<sup>51</sup> For a more detailed discussion, see National Taxpayer Advocate 2006 Annual Report to Congress, Most Serious Problem: IRS Collection Payment Alternatives, 84, 85; National Taxpayer Advocate 2006 Annual Report to Congress, Most Serious Problem: Early Intervention in IRS Collection Cases 62, 66-67; and Status Update: Collection Strategy, *infra/supra*. Unlike other types of installment agreements, "streamlined" installment agreements do not require a time-consuming analysis of the taxpayer's ability to pay. But streamlined agreements are only available for taxpayers who owe less than \$25,000, and can fully pay the liability within 5 years or the period remaining on the collection statute of limitations, whichever comes first. See IRM 5.14.5 (July 12, 2005). Not surprisingly, in fiscal year 2007, over 95 percent of all installment agreements were streamlined. SB/SE Collection Activity Report No. 5000-6 (Oct. 1, 2007).

<sup>52</sup> Accounts are often systemically reported as CNC (called "surveyed," "shelved" or "toleranced"). Although the IRS did collect about \$366 million on cases in CNC status (and \$158 million in refund offsets on accounts in CNC status) in FY 2007, of the accounts reported as CNC in FY 2007, over 60 percent were closed as surveyed or tolerance (43.3 and 17.3 percent, respectively). SB/SE Collection Activity Report No. 5000-149 (Nov. 7, 2007). In some cases, the IRS does enforce collection against taxpayers when it rejects offers or installment agreements. However, one IRS study found that the IRS eventually collected less than 80 percent of what individual taxpayers were offering in most of the offers it rejected or returned after acceptance for processing. 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).

delay makes little sense. IRS research has found that the IRS collects virtually nothing on accounts that remain unpaid after three years.<sup>53</sup> While the IRS may view these actions as a kind of “disposition,” taxpayers do not.

When the IRS fails to present taxpayers who cannot fully pay their taxes with a reasonable plan to resolve the outstanding liabilities, some may be so frustrated that they drop out of the tax system. Those operating in the cash economy can drop out of the tax system much more easily than others. Thus, to address noncompliance in the cash economy the IRS should revise its collection policies so that all taxpayers can resolve their tax liabilities by obtaining a reasonable payment plan or compromise.<sup>54</sup>

### 15. Research what the IRS can do to improve filing compliance among various taxpayer populations.

The IRS should research what it can do to improve filing compliance among various taxpayer populations.<sup>55</sup> For example, research suggests some taxpayers become nonfilers out of a sense of hopelessness when faced with an outstanding tax debt that they cannot afford to pay.<sup>56</sup> Since a significant minority of nonfilers forgo refunds by not filing, they may have a different motivation.<sup>57</sup> Many of these nonfilers may simply be overwhelmed by the complexity of the Code.<sup>58</sup> Thus, different taxpayer populations may require different approaches. The IRS needs to conduct further research to determine which approach is most effective for each taxpayer population.

## Conclusion

The cash economy presents a significant challenge for the IRS. Noncompliance in the cash economy is relatively common and difficult for the IRS to detect. Transactions and even individuals operating in the cash economy often do not even appear in any returns filed with the IRS. Thus, the IRS is going to have to use different strategies to address this problem

<sup>53</sup> IRS, *Automated Collection System Operating Model Team, Collectibility Curve* (Aug. 5, 2002).

<sup>54</sup> For more specific recommendations, see Most Serious Problem, *Offer in Compromise*, *infra*; Status Update: Collection Strategy, *infra*; National Taxpayer Advocate 2006 Annual Report to Congress, Most Serious Problem: IRS Collection Payment Alternatives, 84; and National Taxpayer Advocate 2006 Annual Report to Congress, Most Serious Problem: Early Intervention in IRS Collection Cases 62.

<sup>55</sup> For additional discussion and recommendations to improve filing compliance, see Most Serious Problem, *Nonfiler Program*, *infra*.

<sup>56</sup> Christina M. Ritsema, et. al., *Economic and Behavioral Determinants of Tax Compliance: Evidence from the 1997 Arkansas Tax Penalty Amnesty Program*, 16 (IRS Research Conference 2003), available at <http://www.irs.gov/pub/irs-soi/ritsema.pdf>.

<sup>57</sup> IRS, SB/SE Research, *The Nonfiler Problem - Part II* (Mar. 24, 2006) (indicating that about 35 percent of all W&I nonfilers and about 14 percent of all SB/SE nonfilers are due a refund).

<sup>58</sup> One low income taxpayer clinic described its client base as follows:

[n]ewcomers to the US are frequently entrepreneurial, starting their own small businesses as street vendors, merchants, or food service providers. They tend to use cash and money orders for their expenses, rarely have credit cards or bank accounts, and almost never have any records of their financial transactions — or even copies of their tax returns. Many come from countries where there is no requirement of annual self-assessment of taxes, and these taxpayers often become nonfilers in the US. Language is an incredibly powerful barrier for these taxpayers in all aspects of their life, but it is particularly difficult for them in their attempts to understand and deal with a highly sophisticated and complex administrative and judicial tax system. Testimony of Janet Spragens, Professor of Law and Director, Federal Tax Clinic, American University, Washington College of Law, before the Subcommittee on Oversight of the House Committee on Ways and Means (July 12, 2001).

than it uses to address noncompliance in other areas. While the IRS can never achieve full compliance, if implemented, the recommendations presented in this report should help the IRS make significant progress in improving compliance in the cash economy.

## IRS Comments

The IRS agrees that an unacceptably large amount of the tax that should be paid every year is not, such that compliant taxpayers bear a disproportionate share of the revenue burden, and giving rise to the “tax gap.” The gross tax gap was estimated to be \$345 billion in 2001 and after enforcement efforts and late payments, this amount was reduced to a net tax gap of approximately \$290 billion.

The IRS is committed to improving current compliance levels and continuing to address all forms of noncompliance. Accordingly, the IRS in conjunction with Treasury and the IRS Oversight Board, have developed a comprehensive Strategy for Reducing the Tax Gap. The Strategy sets forth steps that will be taken to improve compliance and enhance the IRS’ ability to measure compliance.

Four key principles guided the development of the strategy and continue to guide IRS efforts to improve compliance:

- Both unintentional taxpayer errors and intentional taxpayer evasion should be addressed;
- Sources of noncompliance should be targeted with specificity;
- Enforcement activities should be combined with a commitment to taxpayer service; and
- Policy positions and compliance proposals should be sensitive to taxpayer rights and maintain an appropriate balance between enforcement activity and imposition of taxpayer burden.

These principles point to the need for a comprehensive, integrated, multi-year strategy to reduce the tax gap. Guided by these key principles, the Strategy for Reducing the Tax Gap outlines seven components which form the basis for the detailed compliance improvement efforts further described in the strategy document:

1. *Reduce Opportunities for Evasion.* The FY 2008 budget request contains 16 legislative proposals to reduce evasion opportunities and improve the efficiency of the IRS. Three of these proposals were recently enacted in modified form. The 16 provisions would result in an estimated \$29.5 billion of additional revenues over the next ten years. The Treasury Department and the IRS also continue to use the regulatory guidance process to address both procedural and substantive issues to improve compliance and reduce the tax gap.

2. *Make a Multi-Year Commitment to Research.* Research is essential to identify sources of noncompliance so that IRS resources can be targeted properly. Regularly updating compliance research ensures that the IRS is aware of vulnerabilities as they emerge. New research is needed on the relationship between taxpayer burden and compliance and on the impact of customer service on voluntary compliance. Research also is essential to establish accurate benchmarks and metrics to assess the effectiveness of IRS efforts, including the effectiveness of the Treasury Strategy.
3. *Continue Improvements in Information Technology.* Continued improvements to technology, including continued development of and additions to modernized e-File, will provide the IRS with better tools to improve compliance through early detection, better case selection, and better case management.
4. *Improve Compliance Activities.* IRS actions have produced a steady climb in enforcement revenues since 2001, and an increase in both the number of examinations and the coverage rate in virtually every major category. By further improving examination, collection, and document matching activities, the IRS will be better able to prevent, detect, and remedy noncompliance. These activities will increase compliance — not only among those directly contacted by the IRS, but also among those who will be deterred from noncompliant behavior as a consequence of a more visible IRS enforcement presence. Aided by results from the recent National Research Program (NRP) study of individual taxpayers, the IRS continues to reengineer examination and collection procedures and invest in technology, resulting in efficiency gains and better targeting of examination efforts. These efficiency gains translate into expanded examination coverage, higher audit yields, and reduced burden on compliant taxpayers.
5. *Enhance Taxpayer Service.* Service is especially important to help taxpayers avoid unintentional errors. Given the increasing complexity of the tax code, providing taxpayers with assistance and clear and accurate information before they file their tax returns reduces unnecessary post-filing contacts, allowing the IRS to focus enforcement resources on taxpayers who intentionally evade their tax obligations. The IRS also is working to provide service more efficiently and effectively through new and existing tools, such as the IRS website. The Taxpayer Assistance Blueprint (TAB), which was completed in April 2007, outlines a five-year strategic plan for taxpayer service. The TAB includes a process for assessing the needs and preferences of taxpayers and partners and a decision model for prioritizing service initiatives and funding.
6. *Reform and Simplify the Tax Law.* Simplifying the tax law would reduce unintentional errors caused by a lack of understanding. Simplification would also reduce the opportunities for intentional evasion and make it easier for the IRS to administer the tax laws. For example, the FY 2008 budget request includes proposals to simplify tax credits for families and tax treatment of savings by consolidating existing programs and clarifying eligibility requirements. These initiatives will continue to be supplemented by IRS efforts to reduce taxpayer burden by simplifying forms and procedures.

7. *Coordinate with Partners and Stakeholders.* Enhanced coordination is needed between the IRS and state and foreign governments to share information and compliance strategies. Expanded coordination also is needed with practitioner organizations, including bar and accounting associations, to maintain and improve mechanisms to ensure that advisors provide appropriate tax advice. Through contacts with practitioner organizations, the Treasury Department and IRS learn about recent developments in tax practice and hear directly from practitioners about taxpayer concerns and potentially abusive practices. Similarly, contacts with taxpayers and their representatives, including small business representatives and low-income taxpayer advocates, provide the Treasury Department and the IRS with needed insight on ways to protect taxpayer rights and minimize the potential burdens associated with compliance strategies.

The more detailed steps outlined for improving compliance are, in part, contingent upon the budget process for FY 2008 and beyond. Accordingly, adoption of the proposed FY 2008 budget for the IRS along with the enactment of the legislative recommendations included as part of that budget are critical components of the strategy to reduce the tax gap.

### Cash Economy Recommendations

The National Taxpayer Advocate focuses her report and recommendation on one aspect of the Tax Gap, which she terms the “Cash Economy”. While we agree that “income that is not subject to information reporting or withholding” is a large component of the tax gap, we are concerned that the use of the term “Cash Economy” is somewhat misleading as some may infer that it includes income from illegal activities, the so-called “underground economy.” The tax gap estimates are derived solely from legal source income.

The IRS agrees that “income that is not subject to information reporting or withholding” does present compliance challenges, and is committed to improving current compliance levels and continuing to address all forms of noncompliance in accordance with our broader tax gap strategy. Many of the recommendations outlined in this report are in fact included in our tax gap strategy, accompanying strategic plans, and the recently completed Taxpayer Assistance Blueprint (TAB). Rather than establishing a separate “Cash Economy Program Office”, our activities will be governed by the broader, but detailed, Strategy for Reducing the Tax Gap, and administered through our strategic planning process and operating units/programs responsible for implementation.

The IRS has an extensive annual strategic planning process through which each of its operating divisions (including the Small Business/Self-Employed Division) develop and estimate resource requirements needed to achieve functional priorities and performance targets based on budget allocations. Detailed action plans, which are part of the IRS’s strategic planning process, identify specific sub-goals and measures as well as accountable parties, and fully support the overarching Strategy for Reducing the Tax Gap. SB/SE’s Stakeholder Liaison Headquarters’ Task Force to Enhance Small Business Outreach, with Service-wide representation, also recently recommended the development of a five-year



outreach strategic plan to more effectively provide outreach and education to the small business community.

### *Research*

The IRS agrees that research is essential to identify sources of noncompliance so that IRS resources can be targeted properly, and the National Taxpayer Advocate's recommendations are consistent with our Strategy for Reducing the Tax Gap. Concerning the recommendation to research and test the effectiveness of a targeted education campaign to improve attitudes about tax compliance, we agree that more could be done in this area and the SB/SE Outreach Strategic Plan will incorporate completed and planned research to ensure education addresses significant non-compliance issues.

One research project in progress focuses on the behavior of taxpayers operating in a cash environment. SB/SE Research is working with a vendor to interview small business owners who primarily operate with cash to determine what types of education may change their behavior to bring them in compliance by reporting the cash income.

SB/SE is also conducting research to connect non-compliance issues to specific industries. This research will provide valuable insight to target educational materials for small business owners within those industries. We will also consider research to segment the small business community into other types of social and behavioral categories.

SB/SE Research (SBR) has completed a number of other studies that aimed to quantify the effect or impact of a particular outreach/education campaign. In the past four years, nine such studies were completed, with varying results. For the most part, past research showed either a positive effect, or no apparent effect. Factors which come into play include the target market segment, the timeframe for the message and the test, the message type and delivery method, the previous tax behaviors, and the desired change. Each outreach campaign will combine a different set of factors. There are also many factors which affect how an outreach campaign will be received and the results it will achieve, many of which are uncontrollable and influenced by the real world environment where outreach campaigns are conducted. For that reason, it is often not possible to be certain that observed changes in tax-related behaviors are the direct result of outreach. While it is not operationally feasible to conduct a measurement study for every outreach or education campaign, additional studies on new market segments or using new techniques will add to the knowledge we have about the impact of outreach.

The IRS also agrees with the recommendation to conduct research to identify tax rules that often confuse taxpayers and provide simplifying guidance. Several SBR research projects are underway that will attempt to quantify where errors on returns are made, and look at whether errors are intentional or accidental (mistakes). One such project will attempt to use NRP data to project schedules and line items where adjustments are most often made. In another study, we are looking at reason codes behind examination assessments

for both Individual Master File (IMF) and Business Master File (BMF) taxpayers, and field and campus sources. The new First-Time Schedule C Filers Strategy will also attempt to develop both long-term and short term actions and messages to assist this market segment. One activity already under discussion is an analysis of the math error codes seen on returns where the first-time filer box on Schedule C is checked. This may be expanded into a multi-year study that tracks the math errors made in the first three or five years of business.

The IRS also interacts with stakeholders to identify issues to improve compliance. They submit these issues for action and implementation through the Issue Management Resolution System (IMRS). IMRS provides a repository for employees to track significant local issues, as well as national and international issues, identified by stakeholders. The system provides trend information to determine when national, international, and high-level significant local issues are systemic and is used to elevate stakeholder issues for resolution. Processes are in place to work issues, determine solutions, recommend changes, and provide resolution or implementation information internally and externally.

### *Income Database*

Concerning the recommendation to create an income database, the IRS concurs that multiple forms of gross receipt information needs to be electronically accessible to properly address under-reporting and non-reporting during selection, classification, matching, and examination processes, and continues to work towards that end. However, a single database approach may not be the best approach and we continue to consider the best alternatives.

Portal technology has advanced to the point that a single or multiple portals can connect to numerous databases and allow a user to data mine or research multiple sources of information. Combining portal technology, Extensible Markup Language (XML), database advances, computer network advances, faster computers, advances in communications, software advances, and low cost electronic storage will allow the IRS to connect, access, and research massive amounts of data from numerous sources.

### *State Matching*

With respect to the recommendation to obtain more state and local receipts-related data, the IRS concurs that that additional state and local information could improve efficiency and effectiveness of compliance efforts to address under-reporting and non-reporting during selection, classification, matching, and examination processes. The National Taxpayer Advocate's recommendation is also consistent with our Strategy for Reducing the Tax Gap.

In addition to actions planned in support of the tax gap strategy, the IRS has a number of initiatives underway. For example, we are reviewing state sales data to identify discrepancies with gross receipts through the State Reverse File Matching Initiative (SRFMI) project. Four states, (Arkansas, Iowa, Massachusetts, and New York) are submitting sales data as



part of SRFMI Phase 2. As part of Phase 2, Examination will assign individual, sales, corporate, and withholding cases for examination.

### *Schedule C Revisions*

Concerning the recommendations to revise the Schedule C to highlight information reporting requirements, the IRS concurs that separating income subject to information reporting from income not subject to reporting on Schedule C may have a positive impact on compliance and selection. Similarly, we concur that the two suggested questions could be added to income tax returns that are required to be filed by sole proprietors, corporations and partnerships, and could potentially have a positive impact on compliance activities. We agree that these measures would improve transparency and potentially reporting compliance. However, these measures would also need to be weighed against the impact to taxpayer burden and additional costs for transcription (as previously discussed in our response to the same recommendations in the National Taxpayer Advocate's 2005 Annual Report to Congress).

The IRS is committed to improving current compliance levels and continuing to address all forms of noncompliance. Accordingly, we have developed a comprehensive Strategy for Reducing the Tax Gap and our initial efforts will be focused on the steps outlined in the Strategy.

### *Preparer Database*

With respect to the recommendation to create a preparer database, the Director of the Office of Professional Responsibility (OPR) and SB/SE Commissioner hosted an IRS Return Preparer Summit in September 2007. The summit included functional representatives from the Taxpayer Advocate Service, Criminal Investigation, Research, Electronic Tax Administration, Appeals, and the other three operating divisions (W&I, TEGE & LMSB). This was a first step toward creating a Service-wide preparer strategy and the recommendation from the National Taxpayer Advocate is only one of the items being considered in development of the strategy. We expect the strategy and supporting action plan to be released in March 2008.

In addition to actions planned in support of the tax gap and return preparer strategies, the IRS has a number of initiatives underway. We have been able to identify some trends, issues, and errors on paid preparer returns through the Examination Operational Automation Database, and subsequently developed fact sheets and targeted outreach and education to address the issues. Some of the annual compliance visits to Electronic Return Originators (EROs) may also be selected based on the frequency of issues and errors identified on e-filed returns.

### *Audit Program & Resources*

Concerning the recommendation to develop a specialized audit unit/program to detect the omission of gross receipts, the IRS has a number of ongoing efforts in this area. SB/SE Examination, Campus Compliance, Fraud, and Collection have many efforts directed at detecting unreported gross receipts and continue to make use of data from multiple sources. We are not clear on what additional actions or activities the specialized audit program as described in the recommendation would include.

The recommendation to conduct research on the most effective use of audit resources after taking into account the effects of IRS activities is also consistent with our Strategy for Reducing the Tax Gap. The steps outlined in the Strategy for Reducing the Tax Gap are, in many respects, only initial steps toward improving compliance. One of the primary challenges that the IRS faces in improving compliance is to obtain a better understanding of the current sources of noncompliance by improving research in this area. Until that understanding is clarified, efforts to improve compliance may be misdirected and progress may not be measurable. The IRS has taken significant steps in this direction, most importantly through the NRP, which is the source of updated estimates of compliance among individual taxpayers for 2001. The IRS is committed to furthering its work in this area through annual individual taxpayer NRP examinations and a current study focusing on compliance among Subchapter S corporations (S corporations).

However, the impact of compliance activities does not lend itself to traditional revenue-estimating analysis, and it is difficult to quantify the effect that such activities have on taxpayer behavior. While audits, for example, are a key tool to combat the tax gap, they are not the only one. Recent NRP data and associated legislative proposals have acknowledged that increasing the transparency and visibility of income may be a more effective means of addressing the cash economy tax gap than targeted audits. Reducing opportunities for evasion is one of the key initiatives in our Strategy for Reducing the Tax Gap and our initial efforts will be focused on the steps outlined in the Strategy. IRS enforcement efforts otherwise have and will continue to be targeted to coverage in high risk categories.

The recommendation to consider clustering audit activity by geographic location and/or industry is already in practice. Another recommendation concerns making resource decisions based on the impact on overall compliance (outreach education combined with audit activity). Alan Plumley's research on the ripple effect of examinations is cited as one of the key pieces of research assessing the indirect effect of examinations. Since his work on the ripple effect, Mr. Plumley has continued to investigate resource optimization based on overall compliance. This is, and remains, a difficult objective to measure with the granularity and frequency needed to run an organization as large and complex as the IRS.

### *Estimated Tax Payments*

Concerning the recommendation to send soft notices or reminders when estimated tax payments are due, the IRS has developed and implemented a number of programs over the past few years to encourage prompt and electronic payments, including:

- Express Enrollment — new businesses with depository requirement are pre-enrolled in the Electronic Federal Tax Payment System (EFTPS);
- Federal Tax Deposit (FTD) Coupon Reorders — based on specific requirements, 20 percent of businesses are pre-enrolled in EFTPS in lieu of receiving an FTD coupon booklet; and
- Individuals making estimated tax payments through electronic funds withdrawal are pre-enrolled in EFTPS and encouraged to make future payments using EFTPS. An enrollment package is mailed to them regarding this program.

With respect to the recommendation to encourage the use of EFTPS by waiving the penalty for one occurrence, we are not certain what impact this recommendation would have as many individuals who deal primarily in cash may prefer not to use EFTPS for their transactions, and may only reluctantly use financial institutions for any transactions. Offering a First Time Abate (FTA) for making estimated tax payments would most likely not improve the payment compliance in that sector. In addition, if the FTA option is the incentive, there is no guarantee that after they use their FTA, the individuals will continue to use EFTPS. Furthermore, a similar process for depository taxes was previously tested; the results did not support continuing this practice and it was terminated in December 2006.

### *Payment Alternatives*

Concerning the recommendation to revise collection policies to offer more reasonable payment alternatives, we believe that current policies and procedures provide sufficient collection alternatives for taxpayers who cannot immediately pay the amounts due in full. For example, the current “streamlined” installment agreement criteria strike the appropriate balance between efficient accounts management, reduced burden for taxpayers, and the need to arrive at realistic payment arrangements consistent with taxpayers’ ability to pay. Taxpayers are generally granted an installment agreement regardless of their actual ability to pay in full on accounts below \$25,000. The IRS also accepts installment agreements for accounts over \$25,000 and in FY07 granted 87,978 installment agreements on accounts over \$25,000. The rate of IAs granted for this population is proportional to the population of these accounts in inventory.

Accounts that do not qualify for installment agreements may be resolved through liquidation of nonessential assets, or collection may be suspended to protect the taxpayer from suffering economic hardship. The “currently not collectible” resolution represents several conditions besides the inability to pay. These conditions include accounts where the IRS is unable to locate or contact the taxpayer, or the taxpayer is in bankruptcy. Accounts are

placed in this status temporarily allowing for consideration in the future when circumstances have changed.

With respect to the comment that IRS collects virtually nothing on accounts that remain unpaid after three years, we question the continued reliability of prior research on collection following the rejection of offers in compromise (Collectibility Curve 2002) and have commissioned updated research into this issue. Our recent experience shows a high rate of self-correction by taxpayers following the inability to reach a compromise with the IRS. We have recently put in place new procedures to facilitate the reassignment of closed offer in compromise cases when another resolution of the case appears appropriate.

Furthermore, for the second year in a row Collection Service-wide dispositions were up eight percent and efficiency<sup>59</sup> increased by nine percent over last year. We have also seen a decline for the third year in a row of total unpaid assessments over four years old, and the percentage of inventory we are working which is less than two years old has continued to increase. These results show that the IRS continues to focus on the currency of our inventory and have achieved productivity gains.

At the same time, the percentage of Automated Collection System (ACS) and field cases resolved through installment agreements has continued to increase, and partial payment installment agreements entered into in FY 2007 were about double the number granted in FY 2006. The total number of installment agreements entered into by the IRS has continued to increase year-over-year, and has more than offset the decline in accepted offers in compromise. Thus, use of collection payment alternatives continues to increase and is trending toward more of those agreements providing for full payment.

### *Filing Compliance*

The IRS agrees with the recommendation to research what can be done to improve filing compliance and a Service-wide Nonfiler Program Plan has recently been developed. The plan focuses on accomplishing three goals:

- Effectively use enforcement to deter filing noncompliance;
- Help taxpayers understand and meet their filing obligations; and
- Leverage technology to identify nonfilers and remove impediments to filing.

The plan was recently approved by the Enforcement Committee and includes the following more specific initiatives:

- Allocate resources based on a Service-wide approach to ensure end-to-end accountability for Nonfiler treatment decisions;
- Develop and implement consistent Service-wide performance and outcome measures to determine impact on filing compliance;

<sup>59</sup> Collection Efficiency Enterprise Measure (volume of collection cases disposed compared to the payroll cost of working them).

- Implement a Service-wide Nonfiler Communication Program that includes an internal and external focus to address filing requirements;
- Expand the use of third party information and research tools to enhance identification, selection and resolution of nonfiler cases;
- Ensure nonfiler cases meeting fraud criteria are referred for civil fraud penalties and/or referred for criminal investigation; and
- Encourage the development and submission of legislative proposals and other regulatory actions to increase filing compliance.

The Service-wide Nonfiler Program will be governed by an Executive Advisory Council which will ensure achievement of outcome and performance goals. Both W&I and SB/SE Research have also used the IRS Nationwide Tax Forums to conduct focus groups with taxpayers and practitioners to gather anecdotal information to help determine why taxpayers file late or sometimes not at all. In addition to ability to pay, results of these efforts list procrastination and poor recordkeeping among the major causes for nonfiling of required returns.

### Taxpayer Advocate Service Comments

Because improving tax compliance in the cash economy is a difficult challenge, the National Taxpayer Advocate has developed and proposed a comprehensive research-based strategy to improve tax compliance while protecting taxpayer rights. This strategy includes both legislative and administrative proposals.<sup>60</sup> While legislation may be required in some areas, the IRS can take additional steps to improve noncompliance on its own, as described in this section of the report.

The National Taxpayer Advocate agrees that the Treasury Department's "Comprehensive Strategy for Reducing the Tax Gap," which the IRS quotes at length in its comments, provides a good general plan for addressing noncompliance. Moreover, the IRS recently unveiled a number of initiatives that will help to implement the strategy.<sup>61</sup> The National Taxpayer Advocate applauds the IRS efforts to identify initiatives to implement the Treasury Department's strategy. Some of these initiatives will help to address noncompliance in the cash economy. The National Taxpayer Advocate is also pleased that the IRS has agreed to adopt several of her recommendations, in whole or in part.

<sup>60</sup> Volume II of this report contains a more detailed discussion of the research used to support the recommendations presented in this volume. See A Comprehensive Strategy for Addressing the Cash Economy, Vol. II, *infra*. For a summary of the National Taxpayer Advocate's legislative recommendations, see Key Legislative Recommendation, *Measures to Address Noncompliance in the Cash Economy, infra*.

<sup>61</sup> The IRS's efforts to implement this strategy are included in its report on improving voluntary compliance. See IRS, *Reducing the Federal Tax Gap, A Report on Improving Voluntary Compliance 2* (Aug. 2, 2007).

However, as a threshold matter, the IRS comments sometimes confuse the term cash economy, with “cash” transactions or commerce conducted by “unbanked” taxpayers (*i.e.*, those who do not have bank accounts) or “underground” (*i.e.*, illegal activities), whereas we clearly use the term to reference legal-source income that is not transparent to the IRS because it is not subject to information reporting or withholding. Moreover, with respect to a number of proposals, the IRS comments are unresponsive or dismissive. In this regard, the IRS response belies its commitment to address the cash economy or the tax gap. A discussion of the IRS comments on each TAS recommendation follows.

### **1. Establish a Cash Economy Program Office to coordinate efforts to improve compliance in the cash economy.**

According to the IRS comments:

Rather than establishing a separate ‘Cash Economy Program Office’, our activities will be governed by the broader, but detailed, Strategy for Reducing the Tax Gap, and administered through our strategic planning process and operating units/programs responsible for implementation.... Detailed action plans, which are part of the IRS’ strategic planning process, identify specific sub-goals and measures as well as accountable parties, and fully support the overarching Strategy for Reducing the Tax Gap.

The National Taxpayer Advocate believes the IRS should take a comprehensive approach to noncompliance in the cash economy that recognizes the unique challenges it presents. As discussed above, the cash economy represents the single largest component of the tax gap, is growing faster than other components, and cannot be effectively addressed with traditional compliance tools because income from the cash economy is not subject to information reporting. Thus, it is useful to analyze and address solutions to noncompliance in the cash economy separately from the overall tax gap.

The IRS’s discrete initiatives that address the portions of the tax gap attributable to the cash economy could be more effective if coordinated by a single person or group that is charged with allocating resources among the initiatives and has responsibility and accountability for measurable compliance results in the cash economy. Indeed, the IRS is taking this approach to the nonfiler component of the tax gap, as discussed at length in the IRS comments above. If IRS managers are instead charged with achieving “sub-goals and measures,” as described in the IRS response, they are more likely to focus narrowly on these sub-goals and measures, and less likely to focus on unique compliance problems presented by the cash economy or to allocate resources most effectively to achieve the ultimate goal of reducing the portion of the tax gap attributable to the cash economy.

**2. Develop a strategic plan for providing services, education, and outreach to small businesses.**

Both the TAS report and the IRS comments acknowledge that an IRS task force recently recommended the development of a strategic plan to more effectively provide outreach and education to the small business community. The IRS response, however, does not commit to implement this recommendation. It should do so.

**3. Research and test the effectiveness of a targeted education campaign to improve attitudes about tax compliance.**

The National Taxpayer Advocate commends the IRS for the research that it has conducted to explore how to increase the effectiveness of a targeted education campaign, and also for agreeing to conduct additional research in this area as recommended above. The National Taxpayer Advocate also recommends, however, that after completing an examination in connection with the NRP that identifies an error on a return, the IRS should determine the reasons why the taxpayer made the error.<sup>62</sup> If the IRS is able to get a better handle on the principle drivers of misreporting, the IRS will be able to target its resources more effectively to address the problem.

**4. Conduct research to identify tax rules that often confuse taxpayers and provide simplifying guidance.**

The National Taxpayer Advocate is pleased that the IRS agrees with her recommendation to conduct research to identify tax rules that often confuse taxpayers and to provide simplifying guidance. As discussed in response to Recommendation 3, above, after the IRS completes an examination in connection with the NRP, it should determine the reasons for the errors identified by the NRP. For those taxpayers who made an error because they were confused, the study should identify the source of the confusion.

**5. Create an “income” database to help identify underreporting and improve audit efficiency.**

The National Taxpayer Advocate and the IRS agree that “multiple forms of gross receipt information needs to be electronically accessible to properly address under-reporting and non-reporting during selection, classification, matching, and examination processes.” However, the IRS is proposing to use “portals” to access data from multiple databases rather than creating a single database. It is unclear to TAS that the IRS could use data portals to reliably recreate all of the functionality of a single income database. The National Taxpayer Advocate believes the IRS’s ultimate goal should be to create a separate income database, unless portals would provide the same functionality as an income database. Moreover, the

<sup>62</sup> This should be a separate study conducted by an outside firm that would sort the errors into “buckets” that correspond to each of the known reasons for noncompliance. See, e.g., Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 U. Kan. L. Rev. 1145 (2003). It could stratify the errors even further to identify areas where clearer rules or outreach might be most useful.

IRS needs a cash economy program office to ensure that the database is used in a consistent and productive way. Such a database would be underutilized if only used for uncoordinated *ad hoc* queries.

**6. Obtain more state and local receipts-related data, match it against income reported on federal income tax returns, and use it to improve audit efficiency.**

According to the IRS comments:

“[t]he IRS concurs additional state and local information could improve efficiency and effectiveness of compliance efforts to address under-reporting and non-reporting during selection, classification, matching, and examination processes.”

The IRS has also been making some progress in using state sales tax data to identify underreported income using its State Reverse File Matching Initiative (SRFMI). It should continue to expand the SRFMI program beyond matching and initiate new programs to use a wider array of state and local data more effectively, as described in TAS’s discussion, above.

**7. Revise Form 1040, Schedule C to break out income not reported on information returns.**

According to the IRS comments, “the IRS concurs that separating income subject to information reporting from income not subject to reporting on Schedule C may have a positive impact on compliance and selection.” However, the IRS did not commit to make this simple form change because, according to the IRS, “these measures would also need to be weighed against the impact to taxpayer burden and additional costs for transcription.” The IRS will likely find these burdens are outweighed by the benefit to the IRS of increased compliance, the benefit to honest businesses of being able to compete on a more level playing field, and the benefit to compliant taxpayers of knowing that underreporting is more likely to be detected. Since the National Taxpayer Advocate first proposed this form change in 2005, the IRS has had two years to weigh its burdens and benefits.<sup>63</sup> Particularly because the IRS agrees that the change may have a positive impact on compliance, the IRS’s failure to implement this proposal has likely resulted in reduced revenue collection. Moreover, any burden associated with this change should be minimal since the law already requires taxpayers to add up the income shown on any information returns to compute their taxable income. Further, any transcription costs should be relatively small and decline further as taxpayers increasingly file electronically. The IRS should immediately initiate this simple common sense form change (and any research needed to verify that the benefits outweigh the burdens) without further delay.

<sup>63</sup> See, e.g., National Taxpayer Advocate 2005 Annual Report to Congress 67-68.



## 8. Revise business income tax return forms to highlight information reporting requirements.

According to the IRS comments:

[t]he two suggested questions could be added to income tax returns that are required to be filed by sole proprietors, corporations and partnerships, and could potentially have a positive impact on compliance activities... these measures would [also] improve transparency and potentially reporting compliance.

However, for the same reason that it did not commit to implement the prior recommendation, the IRS did not commit to make these simple form changes. As with the prior recommendation, since the National Taxpayer Advocate first proposed this form change in 2005, the IRS has had two years to weigh the burdens and benefits, and during this time has forgone the revenue that these simple changes could have generated.<sup>64</sup> Moreover, the burden associated with adding two checkboxes to a return asking taxpayers to verify that they have complied with existing legal requirements is inherently small. For this reason and the reasons stated above, the IRS should immediately initiate these simple common sense form changes (and any research needed to verify that the benefits outweigh the burdens) without further delay.

## 9. Create a preparer database that tracks errors on client returns and use it for targeted outreach and, if outreach fails, possibly for audit selection.

The National Taxpayer Advocate commends the IRS for holding a summit to develop a preparer strategy, which may include the implementation of a preparer database, and for developing targeted outreach and educational materials to address common errors on returns prepared by paid preparers. Moreover, she believes that before implementing a preparer database, the IRS should flesh out the details of how it will design and use it without unfairly penalizing preparers who advise taxpayers to take reasonable good faith return positions with which the IRS simply does not agree.

## 10. Develop a specialized audit program to detect the omission of gross receipts.

Although the IRS response indicates that it has “many efforts directed at detecting unreported gross receipts and continue to make use of data from multiple sources,” the IRS has not identified any specific program or group of revenue agents (or other examination employees) who specialize in identifying unreported gross receipts. The National Taxpayer Advocate continues to recommend that the IRS develop a specialized audit program to detect the omission of gross receipts.

<sup>64</sup> See, e.g., National Taxpayer Advocate 2005 Annual Report to Congress 67-68.

### 11. Research the most effective use of IRS audit resources after taking into account the direct and indirect effects of audits on tax revenue.

The National Taxpayer Advocate applauds the IRS's commitment to conduct annual NRP examinations. However, the IRS, in its comments, does not commit to do any research to identify the most effective use of audit resources, after taking into account the direct and indirect effects of audits on tax revenue. The IRS should initiate such research without delay.

### 12. Make payment compliance easier by sending out estimated tax payment reminders to businesses that have been late in the past.

The IRS comments do not directly address the recommendation to send out letters to remind taxpayers who have been late in the past when their estimated tax payments are due. The National Taxpayer Advocate, the Treasury Inspector General, and the Government Accountability Office (GAO) have all recommended that the IRS at least test such a program.<sup>65</sup> The IRS should do so, as it previously agreed to do in response to GAO's recommendation in 1999, without further delay.

### 13. Encourage taxpayers to pay estimated taxes electronically using the Electronic Federal Tax Payment System (EFTPS).

According to the IRS comments:

With respect to the recommendation to encourage the use of EFTPS by waiving the penalty for one occurrence, we are not certain what impact this recommendation would have as many individuals who deal primarily in cash may prefer not to use EFTPS for their transactions, and may only reluctantly use financial institutions for any transactions. Offering a First Time Abate (FTA) for making estimated tax payments would most likely not improve the payment compliance in that sector. In addition, if the First Time Abate (FTA) option is the incentive, there is no guarantee that after they use their FTA, they will continue to use EFTPS. Furthermore, a similar process for depository taxes was previously tested; the results did not support continuing this practice and it was terminated in December 2006.

As a threshold matter, the IRS comments confuse the cash economy (legal income that is not transparent to the IRS) with income earned by taxpayers who do not have bank accounts. More importantly, there does not appear to be any clear basis for the IRS to conclude that using penalty abatement as an incentive for taxpayers to use EFTPS for depository

<sup>65</sup> See National Taxpayer Advocate 2005 Annual Report to Congress 55, 72 (Most Serious Problem: The Cash Economy); General Accounting Office, GAO/ GGD-99-18, *Billions In Self-Employment Tax Are Owed* 8 (Feb. 1999) and Treasury Inspector General for Tax Administration, Ref. No. 2004-30-040, *While Progress Toward Earlier Intervention With Delinquent Taxpayers Has Been Made, Action Is Needed to Prevent Noncompliance With Estimated Tax Payment Requirements* 19 (Feb. 2004) (recommending that IRS implement a soft notice for estimated tax payments and noting that although IRS planned to implement GAO's soft notice recommendation, it delayed and then canceled the planned implementation). The General Accounting Office has since been renamed the Government Accountability Office.

tory taxes was not successful. This program helped the IRS increase the use of EFTPS for depository tax payments from 64 percent in FY 2005 to 71 percent in FY 2007.<sup>66</sup> Moreover, just because the IRS does not know with certainty that offering penalty abatement would provide a sufficient incentive for taxpayers to use EFTPS does not provide sufficient justification for doing nothing more than what it is currently doing to encourage taxpayers to use EFTPS for estimated tax payments. Further, a first time penalty abatement program would provide “balance” between service and enforcement. The IRS should at least test such an abatement initiative and study the effect of such a program on EFTPS utilization.

#### 14. Revise IRS collection policies to offer a reasonable payment alternative to all taxpayers who cannot fully pay what they owe.

As a threshold matter, the IRS comments state:

With respect to the comment that IRS collects virtually nothing on accounts that remain unpaid after three years, we question the continued reliability of prior research on collection following the rejection of offers in compromise (Collectibility Curve 2002) and have commissioned updated research into this issue.

When the National Taxpayer Advocate recently asked the IRS about updating the collectibility curve, she was told there was no need to update it because the decline in the collection rate on aged accounts is relatively constant. If the IRS now believes that the rate does change, it is extremely important for the IRS to conduct research to verify that assessment and to determine why and how it changes, so it can make informed decisions about how to run its collection programs. The IRS study should not be limited to those taxpayers who file an offer in compromise. To the extent the study looks at taxpayers who submit offers, it should take the IRS’s post-offer collection activity into account. Otherwise, the IRS’s new policy of initiating collection activity against taxpayers who submit offers that it does not accept could bias the study.<sup>67</sup>

The IRS comments also make a number of unsupported factual assertions that TAS has not been able to verify, for example:

**IRS Statement 1:** “The rate of IAs granted for this population (taxpayers with liabilities over \$25,000) is proportional to the population of these accounts in inventory”

**TAS Response 1:** TAS is not aware of any data directly supporting this statement. The IRS states that it granted 87,898 installment agreements to taxpayers owing more than \$25,000. While these agreements (*i.e.*, agreements with taxpayers owing more than \$25,000) represent only about three percent of all installment

<sup>66</sup> W&I, Client Account Services, Response to TAS information request (Oct. 10, 2007). The percentage of depository tax dollars received through EFTPS also increased to a lesser extent, from 96 percent in FY 2005 to 97 percent in FY 2007. *Id.*

<sup>67</sup> Director, Collection Policy, Memorandum for Directors, Collection Area Operations Directors, Compliance Campus Operations, SBSE-05-1107-050, *Updated Procedures to Refer Closed Rejected, Return and Withdrawn Offer Cases for Next Appropriate Action* (Nov. 8, 2007), available at <http://www.irs.gov/pub/foia/ig/sbse/sbse-05-1107-050.pdf>.

agreements granted by the IRS during FY 2007, taxpayers owing \$25,000 or more represented over 16 percent of the cases assigned IRS collection personnel at the end of FY 2007.<sup>68</sup>

**IRS Statement 2:** “We have also seen a decline for the third year in a row of total unpaid assessments over four years old, and the percentage of inventory we are working which is less than two years old has continued to increase”

**TAS Response 2:** Our analysis found the number of accounts assigned to collection personnel (called TDAs) involving tax years 2003 and prior actually rose over 18 percent from FY 2006 to FY 2007.<sup>69</sup>

**IRS Statement 3:** “[P]artial payment installment agreements entered into in FY 2007 were about double the number granted in FY 2006.”

**TAS Response 3:** According to figures previously provided by SB/SE, the IRS accepted about 18,920 partial payment installment agreements in FY 2007, up from 13,328 in FY 2006. Unless the figures the IRS included in its comments to TAS’s report last year were inaccurate, for the number of partial payment installment agreements to double it would have to be 26,656 in FY 2007.<sup>70</sup>

More broadly, the IRS comments do not acknowledge that providing reasonable payment alternatives to taxpayers could help address noncompliance in the cash economy. The IRS asserts that its “current [collection] policies and procedures provide sufficient collection alternatives for taxpayers who cannot immediately pay the amounts due.” A detailed rebuttal of this comment is beyond the scope of this discussion.<sup>71</sup> The National Taxpayer Advocate disagrees with the IRS’s apparent conclusion that its collection programs could not be improved to help address noncompliance in the cash economy.

The IRS should reduce the incentive for taxpayers who cannot timely pay what they owe to drop out of the tax system. It can do so by identifying delinquencies quickly and providing taxpayers with reasonable payment alternatives that do not require them to wait in the IRS’s collection queue or in currently not collectible status while penalties and interest accrue to unmanageable levels, as discussed elsewhere in this report. For example, the IRS should make it easier for taxpayers to pay their taxes in installments without having to go through a contentious and time consuming financial analysis. It should do so by increasing the \$25,000 threshold applicable to “streamlined” installment agreements, which do not

<sup>68</sup> SB/SE Collection Activity Report No. 5000-6 (Oct. 1, 2007).

<sup>69</sup> See *Status Update: Collection Strategy, infra*.

<sup>70</sup> SB/SE Collection Policy, response to TAS information request (Nov. 6, 2007); National Taxpayer Advocate 2006 Annual Report to Congress 102 (IRS Comments to Most Serious Problem: IRS Collection Payment Alternatives).

<sup>71</sup> For a more detailed discussion of IRS collection issues, see Most Serious Problem, *Offer in Compromise, infra*; *Status Update: Collection Strategy, infra*; National Taxpayer Advocate 2006 Annual Report to Congress, Most Serious Problem: IRS Collection Payment Alternatives, 84; and National Taxpayer Advocate 2006 Annual Report to Congress, Most Serious Problem: Early Intervention in IRS Collection Cases 62.

require financial analysis.<sup>72</sup> At the same time, it should continue to refine the allowable expense standards that it uses to make collection decisions so that they are more realistic.<sup>73</sup> The IRS should also make better use of its authority to enter into partial payment installment agreements – agreements that allow taxpayers to pay what they can afford, even if the payment plan does not fully satisfy the liability before the collection statute of limitations expires.<sup>74</sup> In addition, it should issue regulations that preserve the accessibility of the offer in compromise program for those taxpayers most likely to have difficulty providing the 20 percent partial payment that is now required to be submitted to the IRS along with any offer.<sup>75</sup> Moreover, it should do more to educate taxpayers and IRS employees about the availability of offers based on “effective tax administration,” as discussed elsewhere in this report.<sup>76</sup>

#### 15. Research what the IRS can do to improve filing compliance among various taxpayer populations.

The National Taxpayer Advocate is pleased that the IRS agrees with her recommendation to research what the IRS can do to improve filing compliance among various taxpayer populations.<sup>77</sup>

However, the National Taxpayer Advocate notes the seeming inconsistency in the IRS’s response to the nonfiler problem and the overall problem presented by noncompliance in the cash economy. The IRS comments acknowledge the need to create a nonfiler Executive Advisory Counsel to “ensure achievement of outcome and performance goals,” but do not see a need to create a similar cash economy program office or even a cash economy Executive Advisory Counsel. For the same reasons that the IRS has decided to establish an Executive Advisory Counsel to address the nonfiler problem, it should consider establishing a program office or similar group to address compliance problems presented by the cash economy.

<sup>72</sup> The threshold eliminates streamlined installment agreements as an option for taxpayers who owe the IRS more than \$25,000. The IRS has not increased the \$25,000 threshold since it was adopted in 1999. See IRS, *Memo on Streamlined Installment Agreement Procedures Released*, 83 Tax Notes 1572 (June 14, 1999). The \$25,000 threshold should be increased to account for inflation since 1999, and the IRS should consider increasing it further. Penalties, interest and user fees should help discourage taxpayers from using the IRS as a lender. The IRS should study the extent to which a financial analysis is necessary for installment agreements that allow a taxpayer to fully pay his or her liabilities.

<sup>73</sup> An IRS advisory committee recently recommended the IRS: (1) Adjust the Housing and Utility allowance on a zip code basis rather than by county; (2) Encourage IRS revenue officers to use more discretion in the adjustments to take into consideration variations in specific costs and to properly deviate from standard tables, as is currently allowed in IRM 5.15.1.7; (3) Calculate a maximum allowable per credit hour rate for higher education utilizing the cost per credit hour of the state-funded schools in each state; and (4) Revise the out-of-pocket health care standard annually based on trends in health care costs rather than by applying a general cost of living increase. Internal Revenue Service Advisory Council, *IRSAC Releases 2007 Public Meeting Briefing Book*, 2007 TNT 222-46 (Nov. 16, 2007). One commentator also recently recommended the IRS: Consider healthcare expenses incurred less frequently than every 3 months (such as glasses) and include the cost of basic cable and internet service in its expense allowances. Carlton M. Smith, *IRS Collection Financial Standards Changes Bring Relief To The Poor*, 117 Tax Notes 879 (Nov. 26, 2007). The IRS should consider each of these recommendations.

<sup>74</sup> See Status Update, *Collection Strategy*, *infra*.

<sup>75</sup> See Most Serious Problem, *Offer in Compromise*, *infra*.

<sup>76</sup> See Most Serious Problem, *Inadequate Training and Communication Regarding Effective Tax Administration Offers*, *infra*.

<sup>77</sup> For additional discussion of nonfiler issues, see Most Serious Problem, *Nonfiler Program*, *infra*.

## Recommendations

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

1. Establish a Cash Economy Program Office to coordinate efforts to improve compliance in the cash economy;
2. Develop a strategic plan for providing services, education, and outreach to small businesses;
3. Research and test the effectiveness of a targeted education campaign to improve attitudes about tax compliance;
4. Conduct research to identify tax rules that often confuse taxpayers and provide simplifying guidance;
  - 4a. Contract for additional analysis of the reason taxpayers made errors (including errors in interpreting the rules – not just math errors) detected in connection with the NRP, as noted in the TAS comments, above;
5. Create an “income” database to help identify underreporting and improve audit efficiency;
6. Obtain more state and local receipts-related data, match it against income reported on federal income tax returns, and use it to improve audit efficiency;
7. Revise Form 1040, Schedule C to break out income not reported on information returns;
8. Revise business income tax return forms to highlight information reporting requirements;
9. Create a preparer database that tracks errors on client returns and use it for targeted outreach and, if outreach fails, test its effectiveness as a factor in selecting returns for audit;
10. Develop a specialized audit program to detect the omission of gross receipts;
11. Research the most effective use of IRS audit resources after taking into account the direct and indirect effects of audits on tax revenue;
12. Make payment compliance easier by sending out estimated tax payment reminders to businesses that have been late in the past;
13. Encourage taxpayers to pay estimated taxes electronically using the Electronic Federal Tax Payment System (EFTPS);
14. Revise IRS collection policies to offer a reasonable payment alternative to all taxpayers who cannot fully pay what they owe; and
15. Research what the IRS can do to improve filing compliance among various taxpayer populations.

Based on our interpretation of the IRS's comments, it appears the IRS: generally disagrees with recommendations 1, 13, and 14; generally agrees with recommendations 3, 4, 5, 6, and 15; and is undecided or has not yet made a clear commitment with respect to recommendations 2, 5, 7, 8, 9, 10, 11, and 12. The National Taxpayer Advocate looks forward to working with the IRS to implement these recommendations.

MSP  
#4**User Fees: Taxpayer Service For Sale****Responsible Officials**

Richard J. Morgante, Commissioner, Wage and Investment Division  
Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division  
Steven T. Miller, Commissioner, Tax Exempt and Government Entities Division  
Frank Y. Ng, Commissioner, Large and Mid-Size Business Division  
Donald L. Korb, Chief Counsel  
Alison L. Doone, Chief Financial Officer

**Definition of Problem**

Like all federal agencies, the IRS is directed to charge user fees for services that convey “special benefits” beyond those received by the general public,<sup>1</sup> but it may seek an exception from the Office of Management and Budget (OMB).<sup>2</sup> The IRS lacks a consistent policy and specific guidelines for determining whether to charge a fee or seek an exception. The IRS bases such decisions mostly on subjective judgments rather than research and analysis.<sup>3</sup> After deciding to impose a fee, the IRS has the same problem in deciding whether it should seek an exception to waive the fee for low income taxpayers. Furthermore, even when the IRS decides to grant a waiver, it sometimes has difficulty administering the waiver. These difficulties may cause the IRS to inadvertently charge low income taxpayers a fee or improperly deny them service.<sup>4</sup> As a result, the IRS sometimes adopts user fees (and ineffective exceptions) that discourage taxpayers from seeking basic IRS services. Moreover, because IRS services often promote voluntary tax compliance and raise tax revenue, IRS fees could decrease federal revenue.

<sup>1</sup> See 31 U.S.C. § 9701 (explaining: “It is the sense of Congress that each service or thing of value provided by an agency (except a mixed-ownership Government corporation) to a person (except a person on official business of the United States Government) is to be self-sustaining to the extent possible.... [Each agency] may prescribe regulations establishing the charge for a service or thing of value provided by the agency”); Office of Management and Budget, Circular A-25, 58 Fed. Reg. 38,142 (July 15, 1993), available at <http://www.whitehouse.gov/omb/circulars/a025/a025.html> (hereinafter “Circular A-25”) (directing that fees “will be assessed against each identifiable recipient for special benefits derived from Federal activities beyond those received by the general public”).

<sup>2</sup> Section 6(c)(2) of Circular A-25 provides the IRS may apply to the OMB for an exception when “(a) the cost of collecting the fees would represent an unduly large part of the fee for the activity; or (b) any other condition exists that, in the opinion of the agency head or his designee, justifies an exception.” See also 31 U.S.C. § 9701 (providing that fees must be based, in part, on the “public policy or interest served”).

<sup>3</sup> IRS Chief Financial Officer (CFO), Response to TAS information request (Sept. 27, 2007).

<sup>4</sup> According to the Treasury Inspector General for Tax Administration, offer in compromise filings by low income taxpayers declined more than filings by other taxpayers after the offer in compromise fee was imposed even though low income taxpayers were eligible for a fee waiver. Treasury Inspector General for Tax Administration, Ref. No. 2005-30-096, *The Implementation of the Offer in Compromise Application Fee Reduced the Volume of Offers Filed by Taxpayers at All Income Levels* (June 2005).



Before establishing or raising any user fee, the IRS should research both the cost of administering it and the effect of the fee (or fee increase) on the demand for the specific service in question. The IRS should always avoid fees that would:

- Have a significant negative impact on voluntary compliance or IRS collections, or otherwise impair the IRS's ability to accomplish its mission (*i.e.*, the IRS should not charge a fee for services that significantly benefit tax administration);
- Cost more to administer than the IRS could otherwise produce by using the same resources on tax administration;
- Apply to services that taxpayers have little choice in obtaining (*i.e.*, a fee should not be more like a tax or a penalty); or
- Deny basic services to taxpayers who cannot afford them (*i.e.*, the IRS should consider a low income waiver).

## Analysis of Problem

### What is a user fee?

A user fee is a charge to offset the cost of providing a product or service, rather than to raise revenue.<sup>5</sup> In contrast, taxes are imposed to raise revenue, and reflect complex congressional and policy judgments about how to fund government.<sup>6</sup> Unlike user fees, tax revenues typically fund benefits for the public such as national defense and consumer protection.

User fees are also voluntary in that a citizen may avoid a fee by choosing not to obtain a special benefit, such as admission to a national park.<sup>7</sup> Taxes are not voluntary in the sense that citizens cannot simply opt out by choosing not to consume government benefits.

### Advantages of user fees

Proponents of user fees say that these fees can:

- Promote an efficient and fair allocation of scarce government resources to those willing to pay for them;
- Help make government more self-funding; and

<sup>5</sup> In *National Cable Television Ass'n v. U.S.*, 415 U.S. 336, 341 (1974), the Supreme Court explained the difference between a tax and a fee, stating:

Taxation is a legislative function, and Congress, which is the sole organ for levying taxes, may... disregard benefits bestowed by the Government [sic] on a taxpayer and go solely on ability to pay.... A fee ... is incident to a voluntary act ... which, presumably, bestows a benefit on the applicant, not shared by other members of society.

<sup>6</sup> See *National Cable Television Ass'n v. U.S.*, 415 U.S. 336, 341 (1974).

<sup>7</sup> Compare *Bolt v. City of Lansing*, 459 Mich. 152, 587 N.W.2d 264 (1998) (holding that a city's storm water service charges were taxes requiring voter approval rather than user fees, in part, because they were not voluntary) with *Mcleod v. Columbia County*, 278 Ga. 242, 599 S.E.2d 152 (2004) (holding that a storm water charge was a fee, in part, because property owners could reduce the amount of the charge by creating and maintaining private storm water management systems).

- Ensure that those who receive special government benefits are those who are paying for them.<sup>8</sup>

When government and private businesses provide the same services, user fees may also help keep the government from stifling private-sector competition. Moreover, because user fees are voluntary and place an economic burden only on those who receive a benefit, some may perceive them as more “fair” than taxes.<sup>9</sup>

### Disadvantages of user fees

The most obvious effect of fees is to divide users into two categories – those who can pay for special benefits and those who cannot.<sup>10</sup> Improperly applied fees may harm citizens. Opponents of user fees argue that they unfairly restrict citizens’ access to government services simply because of their incomes. Therefore, fees violate the notion that government should serve all members of the public even if they cannot afford to pay.<sup>11</sup>

User fees may also be costly for government agencies to administer. For each new user fee, someone must calculate the proper amount, decide when the fee applies, collect the fee, process the paperwork, periodically adjust it, and account for receipts.<sup>12</sup> Since other IRS activities produce tax revenue, IRS user fees may not be cost-efficient if they divert IRS personnel from activities that bring in more revenue.<sup>13</sup> For example, an installment agreement user fee would not be worthwhile if IRS employees who collect \$400 an hour by processing installment agreement paperwork only generate \$100 an hour when they handle user fee paperwork. User fees may also impose compliance costs on the public; if a fee is subject to a waiver, a taxpayer might be expected to find the waiver forms, determine if he or she is eligible, and document his or her income.

Fees can also discourage people from seeking services that help a government agency fulfill its core mission or benefit the public. As a hypothetical example, assume that an IRS private letter ruling would benefit many taxpayers by identifying an area of complexity and

<sup>8</sup> See, e.g., Clayton P. Gillette and Thomas D. Hopkins, *Federal User Fees: A Legal and Economic Analysis*, 67 B.U. L. Rev. 795 (Nov. 1987); General Accounting Office, GAO-01-179SP, *Principles of Federal Appropriations Law* (2nd ed., Mar. 2001), available at <http://www.gao.gov/special.pubs/d01179sp.pdf>; Congressional Budget Office, *The Growth of Federal User Charges* (Apr. 7, 1994), available at <http://handle.dtic.mil/100.2/ADA277824>.

<sup>9</sup> User fees are also regressive, consuming a greater proportion of income from lower income taxpayers than from higher income taxpayers. See, e.g., Clayton P. Gillette and Thomas D. Hopkins, *Federal User Fees: A Legal and Economic Analysis*, 67 B.U. L. Rev. 795, 814 (Nov. 1987) (noting that fees are fair if it is normatively fair to recoup the costs of services from the service recipient, but unfair if a fair distribution of government services is to allocate them regardless of willingness or ability to pay).

<sup>10</sup> Miriam Drake and Richard Pfister, *The Allocation of Resources from User Fees: A Practical Perspective* 37 (Libraries Unlimited, Inc. 1981).

<sup>11</sup> For additional discussion of fairness considerations, see Laurie Reynolds, *Taxes, Fees, Assessments, Dues, and the “Get What You Pay for” Model of Local Government*, 56 Fla. L. Rev. 373, 441-442 (April 2004) (suggesting that user fees (which she calls “dues”) may not be fair if fairness means that society has some basic obligation to enhance the welfare of all of its citizens even if they cannot afford to pay for the service).

<sup>12</sup> Agencies may recommend fee exceptions “if the cost of collecting the fees would represent an unduly large part of the fee for the activity.” Circular A-25 § 6(c)(2)(a).

<sup>13</sup> Most IRS activities bring in revenue, even if they do so indirectly by encouraging voluntary compliance. For example, studies suggest the indirect revenue gains are between six and 12 times the amount of any proposed audit adjustment. Alan H. Plumley, Pub. 1916, *The Determinants of Individual Income Tax Compliance: Estimating the Impacts of Tax Policy, Enforcement, and IRS Responsiveness* 35-36 (Oct. 1996); Jeffrey A. Dubin, Michael J. Graetz & Louis L. Wilde, *The Effect of Audit Rates on the Federal Individual Income Tax, 1977-1986*, 43 Nat. Tax J. 395, 396, 405 (1990).

legal uncertainty, which the IRS could clarify.<sup>14</sup> As noted above, the IRS's core mission is to "[P]rovide 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."<sup>15</sup> If the fee is too high, it may discourage taxpayers from seeking rulings. Because ruling requests help identify areas in need of official guidance, if the IRS receives fewer requests, it may be less successful in providing clarifying guidance in areas that support its mission.<sup>16</sup> Without this clarifying guidance, some taxpayers will resolve legal uncertainty in their favor to the detriment of the public good. As a result, the fee could reduce IRS's ability to achieve its mission and cost the government more in lost tax revenue than it raises if it increases underreporting of tax. The fee may also lead to higher costs for taxpayers and the IRS by increasing the need for audits and litigation.

Finally, while imposing user fees for essential services is likely to be more effective at raising revenue than charging fees for less important services, such charges are more likely to be seen as unfair. People who use nonessential services, such as admission to a local swimming pool, are more likely to curtail their use of the service because of higher user fees than they are when the government imposes fees on essential services. Raising admission to a pool may produce little additional revenue, since many people will forgo the more costly pool. In contrast, when customers cannot avoid purchasing essential government services (such as utilities), imposing a fee on such services may raise a significant amount of revenue. However, if the service is so essential that it is not voluntary, the charge may be open to legal challenge as a tax or a penalty rather than a fee.<sup>17</sup>

### General authority for the IRS to charge user fees

The Independent Offices Appropriation Act of 1952 (IOAA) authorizes federal agencies, including the IRS, to impose user fees by issuing regulations without specific congressional authorization.<sup>18</sup> Under the IOAA, fees must be "fair" and based on: "(A) the costs to the Government; (B) the value of the service or thing to the recipient; (C) public policy or interest served; and (D) other relevant facts."<sup>19</sup> Although these factors may seem vague and inconsistent, they confirm that the law requires a much deeper analysis than just identify-

<sup>14</sup> While only the taxpayer to whom a private letter ruling is issued may rely on it, private letter rulings often help other taxpayers and practitioners understand the law. See IRC § 6110(k)(3). Moreover, the IRS is more likely to issue a revenue ruling or other guidance once it becomes aware of an area of legal uncertainty. A private letter ruling request, thus, also benefits the public by helping the IRS identify areas where additional guidance would be helpful.

<sup>15</sup> The full IRS mission statement is available at <http://www.irs.gov/irs/article/0,,id=98141,00.html>.

<sup>16</sup> A high private letter ruling fee is most likely to discourage taxpayers from seeking rulings on issues where little tax revenue is at stake. Such issues can still be very important to the public fisc, however, if they affect many taxpayers.

<sup>17</sup> See, e.g., *Bolt v. City of Lansing*, 459 Mich. 152, 587 N.W.2d 264 (1998). If an agency bases its decision to impose user fees on the amount of revenue a given fee is expected to produce, it is likely to impose fees on essential services that are more likely to be regarded as unfair and subject to challenge as taxes. See *id.*

<sup>18</sup> 31 U.S.C. § 9701.

<sup>19</sup> 31 U.S.C. § 9701. OMB has incorporated the requirements of the IOAA and other guidelines into Circular A-25.

ing the special benefits that taxpayers receive from the government and then computing how much it costs to provide them.<sup>20</sup>

### Special authority for the IRS to charge user fees

In 1987, Congress directed the IRS to set user fees for ruling letters, opinion letters, and determination letters based on the cost (measured by average time and difficulty) of complying with the requests in each subcategory.<sup>21</sup> Congress initially made these fees temporary because it wanted to “examine the impact of the provision on taxpayer compliance.”<sup>22</sup> Although we are not aware of any studies on this subject, Congress repeatedly extended these fees and made them permanent in 2007.<sup>23</sup> A separate provision allows the IRS to prescribe “a reasonable fee” for reproduction of returns and the disclosure of return information.<sup>24</sup>

Although agencies generally cannot keep user fee revenue to offset operating expenses, in fiscal year (FY) 1995 Congress allowed the IRS to keep \$119 million of its fees to offset operating expenses.<sup>25</sup> The IRS publicly stated its new fees would be for “special services” and not “mission related” services.<sup>26</sup> It immediately imposed a new \$43 user fee on taxpayers wishing to enter into an installment agreement.<sup>27</sup> The IRS also imposed fees for reinstating or restructuring a defaulted agreement.<sup>28</sup> The IRS raises a significant amount of revenue from installment agreement user fees and expects to collect over \$104 million from these fees in FY 2007.<sup>29</sup>

<sup>20</sup> Commentators have noted:

[T]he IOAA does not constitute a model of clarity and precision. To the contrary, the statute uses vague terms and invokes ephemeral principles that demand substantial interpretation. The statute provides little guidance concerning the constituents of a ‘service or thing of value’ and leaves fairly open the appropriate mechanisms for computing a proper charge. Instead, the statute recites considerations that are, at best, inconclusive, and, at worst, inherently conflicting. Clayton P. Gillette and Thomas D. Hopkins, *Federal User Fees: A Legal and Economic Analysis*, 67 B.U. L. Rev. 795 (Nov. 1987).

<sup>21</sup> See Pub. L. No. 100-203 § 10511 (Dec. 22, 1987); IRC § 7801.

<sup>22</sup> S. Print 100-63 at 205 (Dec. 3, 1987); H. Rept. 100-391 at 1123 (Oct. 26, 1987).

<sup>23</sup> See, e.g., Pub. L. No. 101-508 § 11319 (Jan. 23, 1990); Pub. L. No. 104-117 § 2 (Mar. 20, 1996). In 2003, these provisions were codified at IRC § 7528. Pub. L. No. 108-89 § 202 (Oct. 1, 2003). In 2004, they were extended to 2014 as revenue raisers. Pub. L. No. 108-357 § 891 (Oct. 22, 2004). The Congressional Budget Office estimated that the extension would increase revenues by \$33 million in 2004. Congressional Budget Office, *Cost Estimate for HR 3146* (Oct. 27, 2003), available at <http://www.cbo.gov/ftpdoc.cfm?index=4695&type=0&sequence=0>. In 2007, they were made permanent as a revenue raiser. Pub. L. No. 110-28 § 8244 (May 25, 2007). The Joint Committee on Taxation estimated that making them permanent would raise 30 million per year after 2014. Joint Committee on Taxation, *JCX-30-07, Estimated Revenue Effects of the Small Business and Work Opportunity Tax Act of 2007 and Pension-Related Provisions Contained in H.R. 2206, as Passed by the House of Representatives and the Senate on May 24, 2007* (May 25, 2007), available at <http://www.house.gov/jct/x-30-07.pdf>.

<sup>24</sup> IRC § 6103(p).

<sup>25</sup> 31 U.S.C. § 3302(b) (requiring user fees to be deposited with the Treasury, absent specific statutory authority); Treasury Postal Service and General Government Appropriations Act of 1995, Pub. L. No. 103-329, § 3, 108 Stat. 2,382 (1994) (codified at IRC § 7801 (note)) (allowing the IRS to retain certain user fee receipts). This legislation also limited IRS fees to the actual cost of providing the service.

<sup>26</sup> George Guttman, *Financing the IRS through User Fees*, 65 Tax Notes 658 (Nov. 7, 1994).

<sup>27</sup> T.D. 8589, 60 Fed. Reg. 8,298 (Feb. 14, 1995); Treas. Reg. § 300.0-300.2. According to the preamble of the regulations, the fee for an installment agreement was based on a *blend* of the costs of establishing a new installment agreement at IRS Service Centers (now called Campuses) and District Offices. *Id.*

<sup>28</sup> T.D. 8589, 60 Fed. Reg. 8,298 (Feb. 14, 1995); Treas. Reg. § 300.0-300.2.

<sup>29</sup> CFO Commissioner’s Report (Mar. 2007).

### New IRS user fees and increases in existing fees

The IRS has established several new fees in recent years. For example, in 2003, the IRS imposed a \$150 user fee on applications for offers in compromise.<sup>30</sup> In 2006, the IRS imposed a fee for processing the Application for United States Residency Certification (Form 8802).<sup>31</sup>

Besides establishing new fees, the IRS has recently raised existing ones. OMB Circular A-25 requires agencies to update user fees every two years,<sup>32</sup> and the IRS had not updated the installment agreement fees since first imposing them in 1995. The IRS recently raised the installment agreement user fee from \$43 to \$105 for most taxpayers (low income taxpayers still pay \$43).<sup>33</sup> The IRS also increased the fee for reinstating or restructuring a defaulted agreement from \$24 to \$45.<sup>34</sup> It increased the fee for a copy of a tax return from \$4.25 in 1994 to its current level of \$39.<sup>35</sup> In 2006, the IRS raised many other user fees, as follows:<sup>36</sup>

- The fee for IRS Chief Counsel private letter rulings increased from \$7,000 to \$10,000.<sup>37</sup>
- The fee for requests for changes in accounting methods for businesses increased from \$1,500 to \$2,500.
- The fee for a prefiling agreement for corporate taxpayers increased from a three-tiered structure, capped at \$10,000, to a new flat fee of \$50,000.
- The fee to enter an advance pricing agreement, which previously ranged from \$5,000 to \$25,000, now ranges from \$22,500 to \$50,000.
- Fees for opinion letters for employee plans such as prototype IRAs, SEPs, simple IRAs and Roth IRAs, which previously ranged from \$125 to \$2,570, now range from \$200 to \$4,500.
- Fees for exempt organizations rulings, which previously ranged from \$155 to \$2,570, now range from \$275 to \$8,700.

### User fees can interfere with the IRS's mission

User fees can hinder the IRS's ability to achieve its mission. For example, an officer of a tax-exempt organization asked the IRS whether an item was a "gross receipt" for purpose

<sup>30</sup> T.D. 9086, 68 Fed. Reg. 48,787 (Aug. 15, 2003); Treas. Reg. § 300.3.

<sup>31</sup> T.D. 9266, 71 Fed. Reg. 35154 (June 19, 2006). Form 8802 is used to request Form 6166, a letter the applicant may use as proof of his or her status as a resident of the United States to claim benefits under an income tax treaty or an exemption from a value added tax (VAT) imposed by a foreign country.

<sup>32</sup> Circular A-25.

<sup>33</sup> T.D. 9306, 71 Fed. Reg. 78,074 (Dec. 28, 2006); Treas. Reg. § 300.1; Treas. Reg. § 300.2.

<sup>34</sup> *Id.*

<sup>35</sup> See IRS Form 4506, *Taxpayer Request for a Copy of Tax Return*. Fees collected under IRC § 6103(p) for copies of returns must be "deposited in a separate account which may be used to reimburse appropriations which bore all or part of the costs of such work or services, or to refund excess sums when necessary." IRC § 7809(c)(1).

<sup>36</sup> See Rev. Proc. 2006-1, 2006-1 I.R.B. 1, *superseded by* Rev. Proc. 2007-1, 2007-1 I.R.B. 1; Rev. Proc. 2006-8, 2006-1 I.R.B. 245, *superseded by* Rev. Proc. 2007-8, 2007-1 I.R.B. 230.

<sup>37</sup> A lower fee applies to taxpayers with gross incomes below \$1 million: \$625 for taxpayers with gross income less than \$250,000 and \$2,500 for those with gross income between \$250,000 and \$1 million.

of determining if the organization needed to file a tax return. The IRS initially told her she would have to pay \$8,700 for a ruling before it would provide an answer.<sup>38</sup> In another example, after holding a workshop at a foreign embassy on certain tax rules applicable to embassy staff, the IRS responded to a follow-up inquiry by saying it could only answer questions if the embassy paid \$2,000 for an information letter.<sup>39</sup> In these cases, the IRS's initial response was at odds with its mission.<sup>40</sup> In other words, fees provided the IRS with an excuse for not helping taxpayers "understand and meet their tax responsibilities."

With limited exceptions, the law does not require the IRS to impose any user fees and surely not at the expense of its mission.<sup>41</sup> As noted above, the IOAA requires fees to be based, in part, on "public policy or interest served." OMB Circular A-25 clearly allows exceptions based on such considerations or "any other condition" that justifies an exception.

*The extent of mission impairment is unknown.*

The IRS has no formal published procedures for evaluating user fees.<sup>42</sup> The IRS's draft procedures for computing user fees provide that it may sometimes set prices below full-cost recovery for administrative convenience or to achieve other policy goals.<sup>43</sup> These draft procedures would also require the IRS to project demand for the service and expected changes in demand because of new fees or projected fee increases.<sup>44</sup>

However, the IRS has done little to analyze the effects user fees have on taxpayer behavior, demand for IRS services, or its ability to achieve its policy goals.<sup>45</sup> For example, small business owners have testified in congressional hearings on the negative consequences of high user fees on their decisions about whether to offer employees retirement plans.<sup>46</sup> Yet the IRS has not determined whether user fees have in fact reduced the number of retirement plans small businesses have set up for employees.<sup>47</sup> Nor has it determined if the fee reduced compliance by small businesses that have retirement plans.<sup>48</sup>

<sup>38</sup> As of February 1, 2006, the IRS eliminated the reduced \$625 private letter ruling fee for exempt organizations with gross income of less than \$250,000, raising the fee to \$8,700. See Rev. Proc. 2006-8, 2006-1 I.R.B. 245, *superseded by* Rev. Proc. 2007-8, 2007-1 I.R.B. 230.

<sup>39</sup> On February 1, 2006, the IRS first established a \$2,000 user fee for information letters. See Rev. Proc. 2006-1, §16.02, 2006-1 I.R.B. 1, *superseded by* Rev. Proc. 2007-1, 2007-1 I.R.B. 1.

<sup>40</sup> The full IRS mission statement is available at <http://www.irs.gov/irs/article/0,,id=98141,00.html>.

<sup>41</sup> IRC § 7528 directs the IRS to set minimum fees for a few type of rulings, as described above.

<sup>42</sup> IRS CFO, Response to TAS information request (Sept. 27, 2007).

<sup>43</sup> IRS, *User Fee Handbook* 1.6.7 (May 29, 2002).

<sup>44</sup> IRS, *User Fee Handbook* 1.6.7.3.2 (May 29, 2002).

<sup>45</sup> IRS CFO, Response to TAS information request (Sept. 27, 2007).

<sup>46</sup> *Oversight Hearing on Pension Issues: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 106<sup>th</sup> Cong, 1<sup>st</sup>. Sess. (Mar. 23, 1999) (statement of Paula A. Calimafde, Chair, Small Business Council of America).

<sup>47</sup> IRS CFO, Response to TAS information request (Sept. 27, 2007).

<sup>48</sup> *Id.*

### How the IRS sets user fees

IRS user fees generally may not exceed the cost of providing the service.<sup>49</sup> The IRS's model for determining the cost of services relies on average historical labor cost information and overhead allocations.<sup>50</sup> These averages may not reflect the IRS's typical costs. For example, if workers report their time to complete a task as 9, 10, 11, 20, and 200 hours, the average time is 50 hours ( $250/5 = 50$ ). But to charge all taxpayers for 50 hours of work overstates the cost for most taxpayers. In four out of five cases the IRS spent 20 hours or less, and in most cases it spent 9, 10, or 11 hours. Further, the IRS does not adjust its cost figures to compensate for inefficiencies, such as work expected to take ten hours that ends up taking 30 hours instead. As a result, the IRS's estimates do not always reflect its costs in a typical case.

Moreover, the IRS has no formal process or standard criteria for determining whether a reduced fee or waiver for low income taxpayers is appropriate or to ensure that any user fee waivers are easy for eligible taxpayers to obtain.<sup>51</sup> The IRS's fee for installment agreements illustrates a case where the fee does not reflect actual costs and low income waivers are not well publicized. The analysis below shows why the IRS should revisit installment agreement user fees and others to determine if such fees are appropriate at all.

### An analysis of the IRS's installment agreement user fee

#### *The installment agreement user fee is not based on costs.*

The IRS does not base the installment agreement user fee on the costs incurred in conferring the "special benefit." According to the IRS, the "special benefit" associated with an installment agreement is the ability to pay an outstanding liability over time.<sup>52</sup> There are several types of agreements that cost the IRS different amounts to process: guaranteed, streamlined, partial payment, and regular installment agreements.<sup>53</sup>

Both streamlined and guaranteed installment agreements are relatively low-cost and easy for the IRS to process because it does not have to investigate the taxpayer's financial condition before accepting them. If a taxpayer's liability is less than \$10,000, can be paid within three years, and satisfies various other requirements, he or she is eligible for a guaranteed installment agreement.<sup>54</sup> A taxpayer may enter a streamlined installment agreement if his or her unpaid tax liability is \$25,000 or less and will be fully paid within 60 months or

<sup>49</sup> Treasury Postal Service and General Government Appropriations Act of 1995, Pub. L. No. 103-329, § 3, 108 Stat. 2,382 (1994) (codified at IRC § 7801); IRC § 7809(c)(1) (requiring the IRS to refund fees collected pursuant to IRC § 6103(p) to the extent they exceed actual costs).

<sup>50</sup> IRS, *User Fee Handbook* 1.6.7 (May 29, 2002).

<sup>51</sup> IRS CFO, Response to TAS information request (Sept. 27, 2007).

<sup>52</sup> Notice of proposed rulemaking, 71 Fed. Reg. 51538, 51539 (Aug. 30, 2006).

<sup>53</sup> For a complete discussion, see National Taxpayer Advocate 2006 Annual Report to Congress 83 (Most Serious Problem: IRS Collection Payment Alternatives) and National Taxpayer Advocate 2006 Annual Report to Congress 62 (Most Serious Problem: Early Intervention in IRS Collection Cases).

<sup>54</sup> See IRC § 6159(c).



before the collection statute expires, whichever comes first.<sup>55</sup> In FY 2007, over 95 percent of all installment agreements were either guaranteed or streamlined.<sup>56</sup>

In contrast, the IRS must conduct a costly financial analysis before agreeing to enter a regular or partial payment installment agreement.<sup>57</sup> However, it charges the same fee for each type of installment agreement.<sup>58</sup> The IRS should consider using different fees that reflect the actual costs of the different agreements.<sup>59</sup>

***Many installment agreements provide a greater benefit to the government than the taxpayer.***

For taxpayers who can afford to pay their taxes timely and in full, but choose to pay them over time, statutorily imposed interest and penalties serve as a fee for using the IRS's money and penalty for late payment. Nonetheless, since lenders sometimes impose other closing costs when they extend credit, it may be appropriate for the IRS to impose a user fee in such cases.<sup>60</sup>

For taxpayers who cannot afford to pay their taxes timely and in full, the choice is to either pay their taxes using an installment agreement or not to pay them. The choice for the IRS is to accept the installment agreement, pursue enforced collection, or collect nothing. If enforced collection is more expensive, the government is the primary beneficiary of these installment agreements.<sup>61</sup> The government should not charge a fee for services that mainly benefit the government.

Moreover, in such cases the added cost to the IRS of accepting even the most expensive installment agreements, which require the IRS to analyze the taxpayer's financial condition, is often zero. In deciding whether to pursue enforced collection, the IRS routinely conducts financial analysis to determine a taxpayer's ability to pay. The IRS places a taxpayer's account into "currently not collectible" (CNC) status if it decides not to pursue enforced collection.<sup>62</sup> Since the IRS conducts this financial analysis to determine how to allocate its limited enforcement resources, the IRS is the primary beneficiary of the analysis and does not charge taxpayers a fee when it makes such determinations.

The financial analysis the IRS uses to justify classifying a taxpayer's account as CNC is the same analysis it uses to evaluate whether to accept a regular or partial payment installment

<sup>55</sup> IRM 5.14.5.2 (July 12, 2005).

<sup>56</sup> SB/SE Collection Activity Report No. 5000-6 (Oct. 1, 2007).

<sup>57</sup> IRM 5.14.2.2.1 (July 12, 2005); IRM 5.14.1.5 (July 12, 2005).

<sup>58</sup> The IRS has not responded to TAS requests for the costs and assumptions used to determine the installment agreement user fee. TAS information request to SB/SE June 7, 2007, and e-mail to SB/SE Nov. 9, 2007.

<sup>59</sup> If the IRS determines that the cost of regular and partial payment installment agreements is too high to pass along to taxpayers while fulfilling its mission, it should ask OMB to waive the fee or charge a fee that recovers less than its full cost for those agreements.

<sup>60</sup> Some lenders do not charge for closing costs. They recover such costs by charging a slightly higher rate of interest.

<sup>61</sup> Taxpayers sometimes even ask the IRS to levy their wages to avoid the installment agreement user fee.

<sup>62</sup> IRM 5.19.1.4(30) (Feb. 1, 2006).



agreement. Thus, the IRS does not incur significant extra costs to enter into these types of installment agreements. A taxpayer who cannot pay his or her tax in full saves the IRS money by voluntarily entering into a guaranteed or streamlined installment agreement. The IRS saves money because it does not have to spend resources to determine whether to begin enforced collection or designate the account as CNC and because the taxpayer begins paying the tax debt immediately.

The fee provides a disincentive for taxpayers to come forward and voluntarily resolve outstanding tax liabilities, especially small liabilities the IRS is unlikely to pursue. Yet such cases make up much of the IRS's potential installment agreement work.<sup>63</sup> Thus, if the user fee reduces demand for installment agreements, the government may add enforcement costs and collect less money than the fee raises. The IRS should study such effects before imposing or raising the fee.<sup>64</sup>

***The installment agreement user fee could reduce services to low income taxpayers.***

As previously indicated, the IRS recently raised the fee for an installment agreement from \$43 to \$105. Taxpayers setting up a direct debit installment agreement – which allows the IRS to receive automatic monthly payments from a taxpayer's bank account – pay a reduced rate of \$52, and the fee for low income taxpayers, who might not have bank accounts, remains \$43.<sup>65</sup> The IRS defines low income as less than 250 percent of the federal poverty level.<sup>66</sup> Many qualifying low income taxpayers may not be applying for a reduced fee.<sup>67</sup> Their failure to apply may be the result of poor communication by the IRS or the complexity of the process low income taxpayers are expected to follow to get a reduced fee.<sup>68</sup> The administrative processing costs of collecting and verifying low income forms also lessen the net revenue produced by the fee.<sup>69</sup> Even a \$43 fee still may be a disincentive for some low income taxpayers to come forward and pay tax the IRS is unlikely to collect

<sup>63</sup> Almost 70 percent of all final notices to individuals in FY 2007 involved delinquencies of less than \$3,000. SB/SE Collection Activity Report No. 5000-2/242 (Sept. 30, 2007).

<sup>64</sup> For more information on how the IRS could implement such studies, see Most Serious Problem, *Taxpayer Service and Behavioral Research*, *infra*.

<sup>65</sup> Treas. Reg. § 300.1; Treas. Reg. § 300.2. Low income taxpayers pay the same fee as other taxpayers (\$45) for restructuring a defaulted installment agreement. *Id.*

<sup>66</sup> Memorandum from Director, Collection Policy, 05-1206-052, Interim Guidance Regarding Installment Agreement (IA) User Fees (Dec. 29, 2006), available at <http://www.irs.gov/pub/foia/ig/sbse/sbse-05-1206-052.pdf>.

<sup>67</sup> SB/SE, Response to TAS information request (July 17, 2007). The IRS started processing and reviewing the *Application for Reduced User Fee for Installment Agreements*, Forms 13844, in mid-June 2007. This delay was due to systemic programming limitations. Since the January 2007 implementation, there have been roughly 3,000 forms received. Measurement data (approved, rejected, or returned) will not be available for analysis of low income waiver impact to IAs and OICs until after September 2007. In addition, the IRS is concerned with the low number of applications received and is programming to identify and apply the low income user fee to all qualified taxpayers who were granted an IA during 2007.

<sup>68</sup> A low income taxpayer must fill out Form 13844 to claim the reduced fee. The form instructs the taxpayer to copy the following information from his or her Form 1040: total income from line 22 and the number of dependents claimed on line 6d. The form does not provide instructions for a taxpayer to follow if he or she filed a return on Form 1040A or Form 1040EZ. If the taxpayer filed on Form 1040A or 1040EZ, then he or she must compare his or her income and dependent information to amounts reflected on a chart to determine if he or she is eligible for a reduced fee. If otherwise eligible, the taxpayer must sign, date, and mail the form to the IRS within 30 days of the date of the installment agreement acceptance letter. Since the IRS is asking for information that many taxpayers have already provided on a return, it should design a system to automatically identify taxpayers eligible for the reduced fee.

<sup>69</sup> When low income taxpayers sent the IRS an application for a reduced fee the IRS initially did not timely process many of them. SB/SE, Response to TAS information request (July 17, 2007). Correcting such errors requires additional resources.

on its own. This disincentive may exist even if the IRS is likely to collect the tax on its own since the IRS does not charge a fee when it levies on wages.<sup>70</sup> Thus, taxpayers who feel they cannot afford to pay both the fee and their tax liability will not seek service from the government to help them to pay over time.

***The installment agreement fee may not ultimately raise any revenue.***

The IRS has no compelling reason to charge a user fee for entering into an installment agreement, except that the fee raises a significant amount of revenue.<sup>71</sup> However, IRS employees might raise less revenue per hour administering the fee than they would raise if they could simply process more installment agreements, as discussed above.

***The installment agreement user fee may interfere with the IRS's mission.***

Installment agreements and other collection alternatives help taxpayers and the IRS satisfy tax debts, but user fees on these services interfere with the IRS mission of helping taxpayers “meet their tax responsibilities.” In theory, one might construe many routine IRS services as being eligible for a user fee, such as answering a tax question by telephone, sending a publication, processing a tax return, or sending a refund check. Presumably, the IRS has decided that charging fees for these services does not make sense or would impair its mission. However, the IRS has not analyzed how installment agreement fees make any more sense or impair its mission any less. The IRS's current user fee policies thus appear inconsistent. The IRS should adopt formal procedures for analyzing potential user fees, which include the criteria described above, and reanalyze all of its user fees using this criterion.

## IRS Comments

The IRS is required to impose user fees in compliance with the Independent Offices Appropriation Act of 1952 (IOAA), OMB Circular A-25, and 1987 congressional directives relating to user fees for ruling letters, opinion letters, and determination letters.

## Setting Fees

IRS user fees have existed for many years and the 1995 appropriations act allowed the IRS to retain and spend up to \$119 million annually in user fee receipts to cover corresponding budget cuts. In 2006, Congress eliminated the user fee cap in the appropriations act, allowing the IRS to continue to address reductions in direct appropriations with user fees. Thus, the IRS must fund budget reductions with user fees. In FY 2008, the IRS expects to collect \$180 million in user fees to fund primarily taxpayer services and information technology (IT) programs that support IRS operations. If user fee revenue were removed from IRS funding, and not replaced with appropriated funds, taxpayer service and IT operations

<sup>70</sup> Although the IRS can recover the fee out of the first installment payment, many taxpayers probably are not aware of that. IRM 5.19.1.5.4.3 (June 13, 2007).

<sup>71</sup> As noted above, installment agreement user fees are expected to generate over \$104 million in FY 2007. CFO Commissioner's Report (Mar. 2007).

would be seriously impacted. Over 1,800 FTE would be cut in taxpayer service and progress on improving core IT infrastructure and system security would be slowed significantly.

From 1995 through 2005, there were no significant changes in overall user fees. Existing user fees were increased in 2006, and new fees were added in 2003 and 2006. OMB Circular A-25 requires the IRS to review user fees every two years to determine whether to increase fees or charge new fees. The IRS guidance for calculating the cost of services is consistent with OMB Circular A-25, and the Federal Accounting Standards Advisory Board's Statement of Federal Financial Accounting Standards No. 4 Managerial Cost Accounting Standards and Concepts. The IRS plans to publish the cost calculation guidance provided in the User Fee Handbook in the Internal Revenue Manual by March 2008.

When considering new fees, the IRS evaluates whether to request an exception to charge less than the full cost of the service. For user fees for letter rulings, opinion letters, determination letters, and similar requests governed by § 7528 of the Internal Revenue Code, the IRS is allowed to establish a "reasonable fee" and to provide exemptions and reduced fees when appropriate. The IRS has exercised this discretion by providing deeply discounted fees for taxpayers with low incomes in certain cases. For example, in accordance with OMB Circular A-25 requirements, the IRS requested a waiver from OMB to charge less than full cost for the Offer-in-Compromise user fee in 2003, and later offered a waiver from the fee for low income taxpayers. In addition, in 2007 the IRS requested and received a waiver for low-income taxpayers from the increased \$105 installment agreement fee so that low-income taxpayers continue to pay the original \$43 installment agreement fee.

### Effect of Fees on Taxpayer Service

There is no indication that charging fees for letter rulings discourages taxpayers from seeking rulings or diminishes the ability to identify emerging issues that might benefit from published guidance. For many years, private letter rulings were the primary source for revenue rulings. Now the rulings program is only one source for published guidance projects, and the bulk of the projects on the Priority Guidance plan originate from new legislation, tax administration needs, or suggestions from taxpayers and stakeholders. The focus of the rulings program has always been to provide taxpayers with certainty for return filing purposes, and this special benefit warrants a user fee. However, it should be noted that the IRS is proposing that the user fee for general information letters be eliminated effective February 1, 2008.

The IRS does not charge taxpayers for routine compliance activities. The IRS, however, charges user fees for offers in compromise and installment agreements of taxpayers who elect to use those services rather than paying their full liability when it is due. If taxpayers choose to pay over time without entering into a formal installment agreement, they reduce penalty and interest, and pay down their debt, but have no certainty that the IRS will not enforce collection. The installment agreement eliminates the possibility of enforced collection as long as the terms of the agreement are met.

While demand has declined for the offer in compromise program, the user fee is not the sole reason for the decline. Offer receipts have been declining since FY 2001, before the implementation of the user fee. In addition, the rate of decline in offers in compromise has continued to slow even after implementation of new policies and procedures to implement the down-payment requirement mandated by Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA).

### Installment Agreements

The number of installment agreements increased in each of the last three fiscal years, and there was no decrease in the volume of installment agreements after the fee increased on January 1, 2007. The number of FY 2007 partial payment installment agreements doubled from the number granted in FY 2006. This suggests that the installment agreement user fee has not suppressed tax delinquent taxpayer demand for such services. Because the fee changes to the installment agreement program occurred late in FY 2006, the IRS could not automate the reduced fee for low-income taxpayers in FY 2007. The IRS plans to implement in February 2008 automation that will identify low-income taxpayers at the time an installment agreement is granted, eliminating the need for them to request the lower fee. The IRS is adjusting taxpayer accounts to reduce the fee for those low-income taxpayers who did not apply for the lower rate in FY 2007.

The IRS does not include the cost of financial analysis in the installment agreement fee because it would increase the fee in some cases without lowering the fee in cases in which no financial analysis is performed and because the volume of cases requiring financial analysis is so low (three percent). When the IRS uses financial analysis to decide whether to pursue an installment agreement or another form of resolution, the cost is not borne by the installment agreement program. The most significant cost for the installment agreement program is the processing of payments. The payment transaction cost is the same for all agreements.

Charging an installment agreement user fee only to those taxpayers who can immediately pay in full, but choose to pay over time as a matter of convenience, would not be desirable or cost effective. Administering such a system would require that a financial analysis be performed on every taxpayer requesting an installment agreement in order to differentiate between taxpayers who can pay in full from taxpayers whose limited assets require them to pay over time. This would be significantly more costly and time-consuming than the current system, in which 97 percent of all installment agreements are granted on a streamlined basis with no financial analysis required. Conducting such an intensive analysis of every case would require a substantial increase in the user fee and reduce the overall level of service because of the increased administrative burden.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate commends the IRS for eliminating the user fee for information letters, and for automating the process that allows low income taxpayers to receive a reduced fee when they enter into installment agreements. She is also pleased the IRS intends to incorporate “cost calculation” guidance into the Internal Revenue Manual by March 2008, and expects that the IRS will share this guidance with her for comment before publication.

However, the National Taxpayer Advocate is concerned that in its response, the IRS did not address her recommendations for improving the process for establishing and setting user fees. The National Taxpayer Advocate recommended the IRS study the effect of user fees before imposing them. We also recommended avoiding fees that:

- Could have a negative impact on voluntary compliance or other aspects of the IRS mission;
- Cost more to administer than the IRS could bring in using the same resources on tax administration, apply to services that taxpayers have little choice in obtaining; or
- Deny basic services to taxpayers who cannot afford them.

### *IRS Focus on User Fee Revenue*

The National Taxpayer Advocate is concerned that the IRS’s user fee analysis is driven by a desire to raise revenue without sufficient regard for tax administration goals. The Independent Offices Appropriation Act of 1952 (IOAA) authorizes agencies to charge user fees, but does not mandate any. In fact, it took the IRS the 43 years between 1952 and 1995 to decide to set up any fees based on the IOAA. The IRS became interested in user fees when in 1995 Congress allowed it to retain some of the fees it collected. Since 2006, when Congress removed the limit on user fee collections the IRS could keep,<sup>72</sup> the IRS has been aggressively introducing new fees and raising older ones.

Moreover, the IRS comments acknowledge that this recent legislation prompted the recent fee increases, forcing a choice between raising user fees and cutting important programs. The IRS’s focus on using fees to raise revenue conflicts with the goal of imposing fees that are consistent with sensible tax administration.

<sup>72</sup> IRC § 7801 (note), as amended by Pub. L. No. 109-115 § 209, 119 Stat. 2439, states in relevant part:

The Secretary of the Treasury may spend the new or increased fee receipts to supplement appropriations made available to the Internal Revenue Service appropriations accounts in fiscal years 1995 and thereafter: Provided, That the Secretary shall base such fees on the costs of providing specified services to persons paying such fees: Provided further, That the Secretary shall provide quarterly reports to the Congress on the collection of such fees and how they are being expended by the Service.

### *Effect of Fees on Taxpayer Service*

Although the IRS has not studied the effect of user fees, it states that it has seen “no indication” user fees have affected taxpayer utilization of IRS services. *The IRS should study the effects that user fees are having before concluding they do not have any.* For example, the IRS response states the number of installment agreements has increased in each of the last three fiscal years, and that the January 2007 user fee increase did not discourage taxpayers from entering into new agreements. The IRS does not consider the possibility that even more taxpayers might have entered into new installment agreements if not for the higher fee.<sup>73</sup> Since the IRS does not know how many taxpayers were eligible for an installment agreement from one year to the next, it cannot state with certainty whether a larger or smaller percentage of eligible taxpayers entered into installment agreements after the fee increased. Similarly, the IRS does not have enough information to conclude that the OIC user fee has not discouraged taxpayers from submitting offers.<sup>74</sup>

### *The Transparency of IRS User Fees*

The National Taxpayer Advocate is concerned with the IRS’s lack of transparency in selecting fee services and setting fee amounts, as the IRS increasingly depends on user fee revenue to fund its operations. The IRS has not published any criteria for its operating divisions and functions to use in determining whether a service should be subject to a fee, or established any standard method of setting the fee. As noted above, the National Taxpayer Advocate is pleased that the IRS plans to issue “cost calculation” guidance in 2008. However, this guidance should focus not only on how to compute the IRS’s costs, but also on when to seek a reduced fee or a waiver to achieve sensible tax administration goals.

Moreover, the IRS’s seemingly arbitrary reliance on user fees to pay for taxpayer services can have the appearance of “nickel-and-diming” taxpayers in the short run while endangering taxpayer services in the long run. The IRS’s approach to the installment agreement user fee is illustrative. The IRS’s response suggests that because up to 97 percent of installment agreements do not need the financial analysis, its \$105 fee primarily covers the cost of “processing payments” which is the same for all installment agreements. If we understand this explanation correctly, the IRS is suggesting that it costs about \$105 to “process payments.” *If the payment processing cost is truly this high, the IRS would seem to be so inefficient that it should not be allowed to pass charges for inefficiency along to taxpayers.* Since the IRS has still never fully explained exactly how it came up with its installment agreement user fee structure, however, neither the public nor the National Taxpayer

<sup>73</sup> As the IRS increases its enforcement activities more taxpayers may be responding by requesting installment agreements.

<sup>74</sup> The Treasury Inspector General for Tax Administration (TIGTA) has concluded that the OIC user fee, imposed in November 2003, is responsible for reducing OIC submissions by 28 percent. See Treasury Inspector General for Tax Administration, Ref. No. 2005-30-096, *The Implementation of the Offer in Compromise Application Fee Reduced the Volume of Offers Filed by Taxpayers at All Income Levels* (June 2005). Moreover, according to TIGTA, “filings by taxpayers below the poverty level declined by 36 percent, while filings by taxpayers above the poverty level declined by only 26 percent. Since poverty-level taxpayers are exempt from the \$150 OIC application fee, it is not clear why there was a more significant decline in OIC filings by this group of taxpayers.” *Id.* at 1. For more information on the IRS’s Offer in Compromise fees, see Most Serious Problem, *Offer in Compromise, infra*.

Advocate can fully evaluate it. Such lack of transparency and accountability raises more significant concerns now that the IRS views fees as a way to fund IRS operations.

Likewise, when the IRS focuses on user fees as a source of funding without full transparency, it may be less likely to focus on minimizing tax administration concerns such as effectively processing a fee waiver (or reduced fee) for low income taxpayers. For example, when it established and raised user fees for installment agreements, the IRS initially failed to build in a mechanism for automatically identifying the low income taxpayers eligible for the reduced fee. Only after the Secretary of the Treasury (and the National Taxpayer Advocate) raised concerns about the IRS's implementation of the reduced fee did the IRS address the tax administration problems it presented. Because of the IRS's focus on the revenue raising aspect of user fees, providing efficient service to low income taxpayers may appear to be an afterthought.

Only by publicly basing fee setting decisions on well-reasoned research and analysis can the IRS ensure that its user fee decisions are governed by good tax administration rather than revenue considerations.

## Recommendations

The IRS should publish an analysis of the likely effect of any user fee (or user fee increase) on taxpayers and tax administration before adopting the fee (or fee increase) so the public can be sure the IRS has not put revenue considerations ahead of tax administration considerations when making decisions about user fees. The National Taxpayer Advocate's specific recommendations are as follows:

1. Before establishing or raising any user fee, the IRS should research both the cost of administering it and the effect of the fee (or fee increase) on the demand for the specific service in question. It should also conduct additional research and analysis sufficient to justify the fee and show that:
  - ◆ The proposed fee will not have a significant negative impact on voluntary compliance or IRS collections, or otherwise impair the IRS's ability to accomplish its mission (*i.e.*, the IRS should not charge a fee for services that significantly benefit tax administration);
  - ◆ The proposed fee will not cost more to administer than the IRS could otherwise produce by using the same resources on tax administration;
  - ◆ The fee does not apply to services that taxpayers have little choice in obtaining;
  - ◆ The fee will not deny basic services to taxpayers who cannot afford them (*i.e.*, the IRS should consider a low income waiver); and

- ◆ The services subject to a fee are provided in a reasonably efficient manner so that the fee is not disproportionate to the value received by the service recipient (*e.g.*, a fee of \$105 to “process payments” should not generally be acceptable).
2. The IRS should publish the research and analysis described in recommendation 1 (above) along with a specific explanation showing exactly how it computed any proposed fee or fee increase. The IRS should only implement (or increase) a fee after revising its analysis to address comments from internal and external stakeholders.



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## The Use and Disclosure of Tax Return Information by Preparers to Facilitate the Marketing of Refund Anticipation Loans and Other Products with High Abuse Potential

### Responsible Official

Richard J. Morgante, Commissioner, Wage and Investment Division

### Definition of Problem

Generally, taxpayers should be able to control the use and disclosure of their own tax information. There are situations, however, where consumer protection or tax administration concerns warrant the restriction of taxpayers' use and disclosure of that information. This restriction is particularly warranted where there is a need to protect unsophisticated taxpayers from exploitation. Restriction is further warranted to protect the public fisc by limiting opportunities for return preparers to profit from inappropriately inflating tax refunds.

Section 7216 of the Internal Revenue Code generally prohibits tax preparers from using or disclosing tax return information they obtain from their clients for any purpose other than preparing a tax return. IRC § 7216 also authorizes the Treasury Department to issue regulations permitting certain uses or disclosures. Under the current regulations, tax return preparers use the tax preparation process to sell a variety of products to their clients. The sale of certain commercial products, such as refund anticipation loans (RALs), refund anticipation checks (RACs), and audit insurance are disproportionately targeted toward low income taxpayers and may exploit those taxpayers' trust in their preparers as well as their lack of financial sophistication. In addition, some preparers who market RALs have a financial incentive to inappropriately inflate refund amounts. Further, purchasers of these products may not completely understand that tax preparation and the process of purchasing the product, such as a RAL, are two distinct economic transactions. To the extent that problems arise with a RAL or similar product, taxpayers may incorrectly assume there are problems with the administration of the tax laws. However, despite repeated concerns expressed by both internal and external stakeholders, the IRS has declined to date to conduct any significant research on the impact of commercial products on tax compliance or taxpayer exploitation.

## Analysis of Problem

### Statutory Framework and the Responsibility to Regulate the Marketing of Certain Products and Services

IRC § 7216 imposes criminal penalties on tax return preparers who knowingly or recklessly make unauthorized disclosures or uses of tax return information. In addition, § 6713 imposes civil penalties on tax return preparers for disclosure or use of tax return information unless an exception under the rules of IRC § 7216(b) applies.

Section 7216 generally prohibits the use and disclosure of tax return information by return preparers. The statute provides three limited exceptions to the general rule, one of which authorizes Treasury to prescribe regulations permitting preparers to use or disclose information.<sup>1</sup> However, none of the statutory exceptions require the preparer to obtain the taxpayer's consent to use or disclose tax return information.<sup>2</sup> Preparers may use or disclose tax return information beyond the statutory exceptions *only if, and to the extent that, Treasury regulations expressly authorize such acts*. Thus, taxpayer consent requirements are a regulatory creation, and any ability of the preparers to use or disclose tax return information upon receipt of a taxpayer consent is a result of Treasury regulations authorizing such acts.<sup>3</sup>

### Advanced Notice of Proposed Rulemaking

On January 3, 2008, Treasury and the IRS issued an advance notice of proposed rulemaking (ANPR) describing rules under consideration by the Treasury Department and the IRS regarding the marketing of refund anticipation loans (RALs), refund anticipation checks (RACs), audit insurance, and other substantially similar products or services in connection with the preparation of a tax return. The ANPR would amend the regulations under IRC § 7126.<sup>4</sup>

The ANPR identified two major concerns regarding certain products and services marketed by preparers during the tax return preparation and filing process. The first concern relates to the financial incentive tax preparers have to take improper tax return positions to inappropriately inflate refund claims.<sup>5</sup> The second concern addressed the exploitation of unsophisticated taxpayers, which was raised by commentators to the notice of proposed rulemaking for the proposed regulations under IRC §7216.<sup>6</sup>

<sup>1</sup> IRC § 7216(b)(3).

<sup>2</sup> Statutory exceptions are provided for a "disclosure" pursuant to any other provision of the Internal Revenue Code or an order of a court and for a "use" by a preparer to assist the taxpayer in preparing his or her state and local tax returns and declarations of estimated tax. The statutory language also authorizes the Secretary to prescribe regulations permitting additional exceptions. IRC § 7216(b).

<sup>3</sup> IRC § 7216(b); Treas. Regs. §§ 301.7216-1 to -3.

<sup>4</sup> Department of Treasury, Advance Notice of Proposed Rulemaking, Guidance Regarding Marketing of Refund Anticipation Loans (RALs) and Certain Other Products in Connection with the Preparation of Tax Returns, REG-1365-96-07, 2008-4 I.R.B. (forthcoming Jan. 28, 2008).

<sup>5</sup> The ANPR also identified the concern that the marketing of RALs creates an incentive to not fully comply with due diligence requirements designed to ensure the accuracy of EITC claims.

<sup>6</sup> Department of Treasury, Notice of Proposed Rulemaking, Guidance Necessary to Facilitate Electronic Tax Administration – Updating of Section 7216 Regulations, 70 Fed. Reg. 72,954, REG-137243-02, RIN-1545-BA96 (Dec. 8, 2005).

### Lack of Research on Impact of Commercial Products

Despite numerous and significant concerns expressed by the National Taxpayer Advocate, members of Congress, and numerous stakeholders, the IRS has failed to date to conduct meaningful research addressing the impact certain commercial products have on tax compliance and taxpayer exploitation.<sup>7</sup> This is particularly surprising considering the strong views some senior IRS officials have expressed about commercial products. For example, former IRS Commissioner Mark Everson said in congressional testimony that “the cost of the RALs are significant and as a result they have become a scourge, preying on those people least able to afford turning over a healthy portion of their EITC refund just to get their money a few days sooner.”<sup>8</sup> As discussed below, there are also incentives in the way RALs are sold to inflate refunds, which should cause concerns about the impact on tax compliance. Yet the IRS and policymakers remain hamstrung to a certain extent because the absence of hard data requires us to a large degree to rely on anecdotal evidence.

### Products Create Financial Incentives to Take Improper Return Positions

The National Taxpayer Advocate has repeatedly raised concerns about the extent to which RALs and other ancillary commercial products provide tax preparers with a financial incentive to take unduly aggressive or improper tax return positions in order to artificially inflate refund claims.<sup>9</sup> In accordance with concerns expressed by Treasury and the IRS in the ANPR, the Office of the Taxpayer Advocate believes the existence of such financial incentives to inflate refunds undermines overall tax compliance. In general, tax preparers

<sup>7</sup> See, e.g., *2001 Tax Return Filing Season Hearing Before Subcomm. on Oversight of the H. Comm. On Ways and Means* (Apr. 3, 2001) (statement of Nina E. Olson, National Taxpayer Advocate); *Fraud in Income Tax Return Preparation: Hearing Before Subcomm. on Oversight of the H. Comm. on Ways & Means, 109<sup>th</sup> Cong.* (July 20, 2005) (statement of Nina E. Olson, National Taxpayer Advocate); *Tax Return Preparation Options for Taxpayers: Hearing Before S. Comm. on Finance, 109<sup>th</sup> Cong.* (Apr. 4, 2006) (written statement of Nina E. Olson, National Taxpayer Advocate); National Taxpayer Advocate FY 2007 Objectives Report to Congress, vol. II, *The Role of the IRS in the Refund Anticipation Loan Industry*, (June 30, 2006); *Preparing Your Taxes: How Costly Is It?: Hearing Before S. Comm. on Finance, 109<sup>th</sup> Cong.* (Apr. 4, 2006) (Statement of Sen. Charles Grassley, Chairman); S. Rep. No. 109-336, at 86-90 (2006) (stating the Finance Committee’s concern “that tax return preparers are exploiting their position of trust to market products and services unrelated to the preparation of a tax return.”); National Association of Attorneys General, *State Attorneys General Criticize IRS Proposal on Taxpayer Data Disclosure*, Tax Notes Today, 2006 TNT 65-17 (Apr. 5, 2006) (Joint letter from 46 state attorneys general stating that “[t]he undersigned Attorneys General are acutely aware of the many private and public lawsuits involving unlawful practices associated with refund anticipation loans, the most prevalent by-product of tax-information sharing. Little would be lost, and much gained, by banning the sharing of tax return information with the banks that provide these high-interest loans.”); *State v. H&R. Block, Inc.*, 2007 N.Y. Slip Op. 51562(U) (N.Y. Sup. Ct. July 9, 2007); Alan Berube, The Brookings Institute, *The Price of Paying Taxes: How Tax Preparation and Refund Loan Fees Erode the Benefits of the EITC* (2002); Alan Berube & Tracy Kornblatt, The Brookings Institution, *Step in the Right Direction: Recent Declines in Refund Loan Usage Among Low-Income Taxpayers* (April 2005); Taxpayer Advocacy Panel 2005 Annual Report to Congress 44-45; Consumer Federation of America and National Consumer Law Center, *Tax Preparers Peddle High Priced Tax Refund Loans: Millions Skimmed From the Working Poor and the U.S. Treasury* (Jan. 31, 2002); National Consumer Law Center, Consumer Federation of America, and U.S. Public Interest Research Group, *Comments Regarding Notice of Proposed Rulemaking Amendments to Section 7216 Regulations and Revenue Guidance* (Mar. 8, 2006).

<sup>8</sup> *Reporting Improper Payments: A Report Card on Agencies’ Progress: Hearing Before the Subcomm. on Federal Financial Management, Government Information, Federal Services, and International Security of the S. Comm. On Homeland Security and Governmental Affairs, 109<sup>th</sup> Cong.* 5 (Mar. 9, 2006) (written statement of Mark Everson, Commissioner of Internal Revenue).

<sup>9</sup> See, e.g., National Taxpayer Advocate’s Report to Congress, Fiscal Year 2007 Objectives, *The Role of the IRS in the Refund Anticipation Loan Industry*, Vol. II (June 30, 2006); *Tax Return Preparation Options for Taxpayers: Hearing Before S. Comm. on Finance, U.S. Senate, 109<sup>th</sup> Cong.* (Apr. 4, 2006) 1-5 (Written Statement of Nina E. Olson, National Taxpayer Advocate); *Fraud in Income Tax Return Preparation: Hearing Before Subcomm. on Oversight, H. Comm. On Ways & Means, 109<sup>th</sup> Cong.* (July 20, 2005) (Statement of Nina E. Olson, National Taxpayer Advocate).

and RAL providers, in combination, receive higher RAL fees for higher RAL amounts.<sup>10</sup> In addition, merchants who market RALs in connection with their tax preparation services may also have an independent financial incentive to inflate the amount of refunds claimed. These merchants may promote RALs and encourage customers to spend loan proceeds on products or services offered by the merchant. For example, an automobile dealership may offer on-site tax preparation services and encourage taxpayers/customers to purchase RALs and use the proceeds as a down payment for a car or truck.<sup>11</sup> From a merchant's perspective, the higher the refund claimed, the more money the customer can spend on the merchant's products. Thus, preparers marketing RALs have an incentive to increase the refund to maximize the loan.<sup>12</sup>

Considering the above-discussed statutory framework of IRC § 7216, the National Taxpayer Advocate believes it is the responsibility of Treasury and the IRS to regulate products that impact the integrity of the tax system. Treasury Department Circular 230 generally prohibits tax practitioners from charging contingent fees for the preparation of original tax returns.<sup>13</sup> Although Circular 230 does not cover RALs because the preparer benefit arises from the sale of an ancillary product rather than directly from the determination of a taxpayer's tax liability, the tax administration concerns are the same.<sup>14</sup> In addition, IRS Publication 1345, Handbook for Authorized IRS e-file Providers for Individual Income, prohibits electronic return originators (EROs) from basing their fees on the amount of the refund.<sup>15</sup> Even though practitioners covered by Circular 230, as well as EROs, are prohibited from accepting fees contingent upon the amount of the refund, these same individuals may still be indirectly receiving fees measured by the size of the refund, by facilitating RALs.

The marketing of RACs<sup>16</sup> and audit insurance<sup>17</sup> products by tax preparers also creates concerns about the integrity of the tax system. A preparer will only receive a fee for selling a RAC if the taxpayer's return shows a refund. Further, because audit insurance products compensate taxpayers for expenses incurred when their returns are selected for audit, taxpayers who have purchased the insurance, and their preparers, may feel emboldened to take overly aggressive positions on tax returns.

<sup>10</sup> For example, H&R Block buys a 49.9 percent participation interest in all RALs obtained through its retail outlets. In Fiscal Year 2007, the company earned \$192.4 million in participation revenue, which is calculated as the rate of participation (49.9 percent) multiplied by the fees paid by borrowers to the lending bank. H&R Block Inc., 2007 Form 10-K, at 4 (June 29, 2007). Thus, H&R Block ultimately earns approximately half of the RAL fees paid by the borrower to the lending bank. Each RAL fee is based on the size of the loan and generally increases as the size of the loan increases up to a certain cap.

<sup>11</sup> See, e.g., *Taxpayer Alert: Choosing a Paid Preparer and the Pitfalls of Charitable Car Donation: Hearing Before S. Comm. On Finance, 108<sup>th</sup> Cong.* (Apr. 1, 2003) (oral testimony of Nina E. Olson, National Taxpayer Advocate).

<sup>12</sup> For a more detailed discussion of financial incentives received by preparers facilitating RALs, see National Taxpayer Advocate Fiscal Year 2007 Objectives Report to Congress, *The Role of the IRS in the Refund Anticipation Loan Industry*, Vol. II (June 30, 2006).

<sup>13</sup> See 31 C.F.R. § 10.27(b).

<sup>14</sup> The preamble to the final Circular 230 regulations includes the following statement "The Treasury Department and the IRS continue to believe that a rule restricting contingency fees for preparing tax returns supports voluntary compliance with the federal tax laws by discouraging return positions that exploit the audit selection process." Preamble, 31 C.F.R. Part 10 (Sept. 19, 2007).

<sup>15</sup> IRS Publication 1345, Handbook for Authorized IRS e-file Providers for Individual Income 45.

<sup>16</sup> A RAC is a post-refund product that allows taxpayers to pay for return preparation services out of their refunds.

<sup>17</sup> Audit insurance is a type of insurance that covers professional fees and other expenses incurred in responding to or defending against an audit by the IRS.

### Potential for Exploitation of Taxpayers

After Treasury published proposed regulations under IRC § 7216 in a notice of proposed rulemaking on December 8, 2005,<sup>18</sup> several commentators raised concerns regarding the practice of some tax preparers marketing RALs and certain other products to taxpayers. For example, a letter from the National Association of Attorneys General, signed by 46 state attorneys general, stated:

We believe that the best, most prudent course for the Service to take is simply to prohibit tax preparers from sharing tax return information for purposes unrelated to the preparation of tax returns. There is simply too much at risk for American taxpayers, particularly with respect to the ongoing scourge of identity theft, to increase the likelihood that their most personal information will be stolen or misused. Crucially, there is no pressing need to put that information at risk: American consumers' financial information is already copiously provided to businesses offering financial services and related products. We are aware of no complaints from taxpayers that they receive too few solicitations from these companies.<sup>19</sup>

Concerns surrounding the marketing of certain products during the tax preparation process have also received congressional attention. In 2006, the U.S. Senate Committee on Finance approved legislation that would have prohibited the use or disclosure of tax return information for non-tax preparation purposes.<sup>20</sup> In explaining this provision, the accompanying committee report stated:

The use of tax return information as a source of clients or data for use in non-tax preparation lines of business is troubling to the Committee. The Committee is concerned that tax return preparers are exploiting their position of trust to market products and services unrelated to the preparation of a tax return. There has been considerable publicity regarding sales of refund anticipation loans and other financial products purchased from tax preparers, largely by low-income taxpayers, for excessive fees or low rates of return. Taxpayers may not understand how the products work, or even that they are giving consent to these products or services as part of the stack of forms they sign during the tax return preparation process. As a result, the Committee believes it is appropriate to prohibit the use or disclosure of tax return information for a non-tax preparation purpose.

The National Taxpayer Advocate is concerned about the effect of taxpayer exploitation on tax compliance. It is questionable whether RAL purchasers understand the terms of the

<sup>18</sup> Department of Treasury, Notice of Proposed Rulemaking, Guidance Necessary to Facilitate Electronic Tax Administration – Updating of Section 7216 Regulations, 70 Fed. Reg. 72,954, REG-137243-02, RIN-1545-BA96 (Dec. 8, 2005).

<sup>19</sup> National Association of Attorneys General, State Attorneys General Criticize IRS Proposal on Taxpayer Data Disclosure, Tax Notes Today, 2006 TNT 65-17 (Apr. 5, 2006).

<sup>20</sup> See S. 1321, 109<sup>th</sup> Cong. § 512(a) (2006) (as reported in the Senate).

products<sup>21</sup> or fully appreciate that the act of return preparation and that of purchasing a RAL are two distinct transactions. Accordingly, where a taxpayer has a bad experience with a RAL (e.g., the IRS disallows the anticipated refund or uses it to offset another liability and the taxpayer ends up owing the RAL provider a debt), the taxpayer may blame the IRS for the problem and be less likely to comply with tax obligations in the future.<sup>22</sup>

**Impact on Tax Compliance**

IRS data for tax year 2004 provides a limited illustration of the tax compliance costs that may result from RALs. The following table compares audits of TY 2004 individual tax returns claiming the earned income tax credit (EITC) with RAL indicators to audits of 2004 individual tax returns claiming the EITC without RAL indicators.

**TABLE 1.5.1, Audits Of Tax Year 2004 Non-RAL EITC Returns vs. RAL EITC Returns<sup>23</sup>**

Type of Return	Average Audit Adjustments (Tax Amounts)	Average EITC Claimed on Audited Returns	No Change Percentage
EITC Returns Without RALs	\$2,941	\$2,833	27%
EITC Returns With RALs	\$3,264	\$2,960	13%

As shown, audits of TY 2004 EITC returns with RAL indicators have a significantly lower no change rate than audits of TY 2004 non-RAL EITC returns. In addition, RAL returns produced higher average audit adjustments.

The above concerns regarding financial incentives to market certain products and the potential for exploitation can be illustrated by the following example.

**Example:** An automobile dealer provides tax preparation services to taxpayers. For each taxpayer who is due a refund, the dealership preparer *uses* the tax return information to offer the taxpayer a RAL, which will allow the taxpayer to make a down payment on a car. The preparer has a financial incentive to not only offer the RAL but to prepare a return with the largest possible refund claim to allow the taxpayer to buy and finance a more expensive vehicle. If the taxpayer agrees to purchase a RAL, the preparer will *disclose* to a financial institution the taxpayer’s tax return information as well as information regarding the existence of any outstanding government debts owed by the taxpayer. If the financial institution

<sup>21</sup> A series of postings on an American Bar Association’s online discussion forum for Low Income Taxpayer Clinics described the cross-collection practice of RAL providers and the lack of knowledge of these practices by both practitioners and taxpayer clients who purchased RALs. American Bar Association Low Income Taxpayer Clinic Discussion, ABA-TAX LITC Postings (Aug. 17, 2007).

<sup>22</sup> For a detailed discussion of the National Taxpayer Advocate’s concerns regarding RALs, see The National Taxpayer Advocate’s Report to Congress, Fiscal Year 2007 Objectives, Vol. II, The Role of the IRS in the Refund Anticipation Loan Industry (June 30, 2006).

<sup>23</sup> Audit Information Management System (AIMS) database, IRS Compliance Data Warehouse (Encompasses Tax Year 2004 audited individual income tax returns where the audit was closed as of June 2007). The EITC data is from the Individual Returns Transaction File on the IRS Compliance Data Warehouse and includes tax year 2004 returns.



approves the loan, the loan proceeds are immediately assigned to the automobile financing company for the down payment and the taxpayer drives away in the car. If the IRS does not release the taxpayer's total anticipated refund due to subsequent compliance screens, the taxpayer will default on the RAL. Furthermore, if the taxpayer does not pay back the entire amount due on the defaulted RAL by the time he or she takes out an additional RAL in a future tax year, the financial institution for the second RAL will act as a debt collector on behalf of the first financial institution for the previously defaulted RAL. Although the taxpayer signed loan agreements detailing the practices of the financial institutions, it is likely that the taxpayer did not completely understand the consequences of the RAL transaction. The taxpayer may also assume the federal government played a role in his or her resulting credit problems, because the entire transaction was predicated upon the requirement to file a federal income tax return.<sup>24</sup>

### Striking a Balance with Free Market Principles

While it is important to allow taxpayers to receive information relevant to their financial status and have the ability to choose products and services of interest to them, Treasury and the IRS have a responsibility to protect taxpayers who have been harmed by certain products and services associated with the tax preparation and filing process. Other federal agencies also have struggled to balance the goal of allowing individuals to control their own financial decisions against the objective of protecting these individuals from potential financial harm or exploitation. For example, the Securities and Exchange Commission (SEC) has confronted this challenge in deciding whether to allow individuals to invest in the private placement of securities. Recognizing that private placements present greater risks than public offerings, the SEC authorizes private placements only if the issuer of a security agrees to limit sales to investors who are "accredited investors" or, in the case of a purchaser who does not qualify as an accredited investor, if the issuer of a security reasonably believes the purchaser or the purchaser's representative "has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment." An individual is considered an accredited investor if he or she meets certain net worth or income requirements.<sup>25</sup> This longstanding and widely accepted regulatory regime, known as "Regulation D," restricts the ability of many individuals to invest in private placements to protect them from potential financial harm.

Because the IRS shares some of the same consumer protection concerns the SEC faces in regulating private placements, a similar approach should guide the regulation of the tax return preparation and filing industry. In fact, the IRS has already taken steps, in the interest of tax administration, to limit consumers' choices. In response to concerns regarding the marketing of ancillary products in connection with the Free File program, the IRS and

<sup>24</sup> See, e.g., *Taxpayer Alert: Choosing a Paid Preparer and the Pitfalls of Charitable Car Donation: Hearing Before S. Comm. On Finance, 108<sup>th</sup> Cong.* (Apr. 1, 2003) (oral testimony of Nina E. Olson, National Taxpayer Advocate).

<sup>25</sup> 17 C.F.R. §§ 230.501 and .506.

the Free File Alliance agreed to remove such marketing practices from the program for the 2007 filing season.<sup>26</sup>

### Effect of Proposed Amendments on the Return Preparation Process

The contemplated regulations detailed in the ANPR would separate the act of return preparation from the act of marketing those products specifically carved out. Tax return preparers would be prohibited from using or disclosing information obtained during the return preparation and filing process for the purpose of marketing these products. For example, taxpayers and RAL providers could continue to enter into short-term loan arrangements, but would have to do so outside the context of the tax return preparation process. The preparer could not directly influence the decision of a taxpayer to purchase such products and the marketing of the products would not directly influence the tax return preparation process. In addition, in the case of RAL purchases, it would be clear to the taxpayer that the federal government played no role in the loan transaction.<sup>27</sup>

### Conclusion

With the existing statutory framework of IRC § 7216, Treasury has the discretion to restrict the ability of preparers to obtain taxpayer consent to either use or disclose tax return information in the marketing of RALs, audit protection, and similar products. The statute contains a broad prohibition against the use and disclosure of tax return information by preparers. Because the consent-based exceptions to the general rule are a regulatory creation, Treasury and the IRS have the responsibility to look to the best interests of tax administration as well as protect taxpayers against exploitation.

### IRS Comments

The National Taxpayer Advocate is right to stress the importance of striking the balance between taxpayers' control over the use of their tax information and the potential for abuse. However, the IRS must have reliable data prior to taking any regulatory actions that will curtail a taxpayer's ability to disclose his or her own tax information. That is why

<sup>26</sup> In a news release announcing the elimination of ancillary product solicitations from Free File, the IRS cited a study conducted by Russell Research which found that approximately half of the Free File users who purchased ancillary products in 2006 did not intend to make the purchase. Approximately six percent of all Free File users, or 230,000 taxpayers, filed using the Free File program and bought an ancillary product in 2006. IRS News Release, RALs Removed on Free File; 93 Million Eligible for Program (Dec. 5, 2006); IRS 2007 Free File Program Weekly Snapshot (Oct. 18, 2007).

<sup>27</sup> The National Taxpayer Advocate is aware that some taxpayers purchase RALs and other commercial refund delivery products as a means to pay the fees associated with tax return preparation and filing. However, the IRS has the ability to provide return preparation to taxpayers who cannot afford to pay. Specifically, the IRS should direct more resources to expand the Volunteer Income Tax Assistance Program (VITA) and free return preparation services provided at Taxpayer Assistance Centers (TACs). The IRS should expand return preparation services provided at TACs rather than decrease such services. See, e.g., National Taxpayer Advocate 2005 Annual Report to Congress 2-24; National Taxpayer Advocate 2004 Annual Report to Congress 8-25, 110-131; H.R. Rep. No. 110-207, Pt. 1 (June 22, 2007) (The House Committee on Appropriations stated "Volunteer services should supplement, not replace, IRS services. The Committee notes that the IRS Oversight Board and the IRS National Taxpayer Advocate have both stressed the continued importance of IRS services related to outreach and education, and the IRS National Taxpayer Advocate has additionally stressed the importance of maintaining IRS assistance in preparing tax returns. ...The Committee directs IRS to strengthen, improve, and expand taxpayer service."). In the Consolidated Appropriations Act, 2008, Congress appropriated funds to the IRS to establish and administer a Community Volunteer Income Tax Assistance matching grants demonstration program for tax return preparation assistance. *H.R. 2764, 110 Cong., Div. D, Tit. 1* (Signed by President on Dec. 26, 2007).



the Treasury Department and IRS published an Advance Notice of Proposed Rulemaking (ANPR) seeking public input on the issue.

The ANPR also notes the importance of good tax administration and cites the potential that financial incentives may encourage tax return preparers to take improper tax positions to inflate refunds. We anticipate public comment on the issues raised in the ANPR will help inform the discussion and facilitate further planned IRS research into the relationship between return preparation and ancillary financial products, including refund anticipation loans (RALs) and refund anticipation checks (RACs).

As is evident from the footnotes in the National Taxpayer Advocate's report, this is an area that has been well covered in prior reports. In addition, the IRS provided a report to Congress on the use of the Debt Indicator as directed in the FY 2006 Treasury Appropriations bill.<sup>28</sup> This report was prepared in consultation with the National Taxpayer Advocate and provides a balanced analysis of many of the issues raised here, including the legality of RALs, taxpayers' understanding of RAL products and processes, the banking and consumer protection laws that regulate RAL loans, the role of electronic return originators in the RAL process, and taxpayer consent to disclose tax information to RAL lenders.

### **The Nature and Scope of the Problem are Unclear**

The National Taxpayer Advocate cites several anecdotal or hypothetical situations as evidence there is a potential for tax preparers to inflate refunds. For example, the National Taxpayer Advocate states that revenue for a large tax preparation company increases at the corporate level with the amount of refund anticipation loans it facilitates at the retail level. However, this does not support the conclusion that at the retail level – during the actual tax return preparation process – preparers have incentives to increase the size of their clients' refunds in order to make larger refund anticipation loans. In fact, IRS rules in Publication 1345, p. 45, specifically require that preparers charge a flat fee for processing a RAL regardless of the size of the loan. There is scant, if any, substantive evidence that individual tax preparers are directly or indirectly receiving fees or profit based on the size of RALs.

The National Taxpayer Advocate also cites the possibility that merchants that provide tax preparation services may encourage customers to obtain a RAL and spend it on products or services offered by the merchant. Free tax preparation and application of the RAL to a down payment is a marketing ploy similar to loss leaders, rebates, zero percent interest loans, or guaranteed trade-in amounts frequently used by automotive and other retailers. In this scenario it is possible there are incentives for tax preparers to inflate the size of refunds associated with RALs. However, what remains unclear is whether preparers are actually engaging in such behavior and, if so, how widespread it may be.

<sup>28</sup> Debt Indicator Report to Congress, October 31, 2006, as requested by the United States Senate in the adoption of the Akaka amendment to HR 3050, the Transportation, Treasury and Postal Service Appropriation bill for FY 2006.

Finally, the National Taxpayer Advocate cites a difference in audit change rates for taxpayers with and without RALs and suggests RALs are a factor in noncompliance. However, it is likely there are many other variables that contribute to this difference in audit adjustments, including return characteristics such as AGI, dependent exemptions, EITC, the refundable Child Tax Credit, etc. Before reaching the conclusion that RALs encourage noncompliance, much more research and analysis are needed.

### **Taxpayers Should be Able to Control the Use and Disclosure of Their Own Tax Information in Most Cases**

The IRS shares the National Taxpayer Advocate's concern that the tax preparation process not be used to exploit unwitting taxpayers. However, the IRS has generally made the determination that ensuring taxpayers have clear and complete information about their choices is the best way to combat potential exploitation. That is why the Treasury Regulations issued under § 7216 require a signed, informed consent by the taxpayer to disclose his or her tax information. The Health Insurance Portability and Accountability Act (HIPAA) requires similar consent for medical record disclosures.

Consistent with Treasury Regulation § 301.7216, the IRS is reluctant to limit the abilities of taxpayers to control the disclosure and use of their own tax information. However, such limits may be justified in situations where it is impossible to provide taxpayers with the information they need to make informed decisions. The ANPR seeks public comment on exactly this question with regard to taxpayer disclosure consents related to RALs and RACs at the time tax returns are prepared.

The National Taxpayer Advocate cites the Regulation D regime imposed by the Securities and Exchange Commission (SEC) as an example of government determining that certain citizens are not well enough informed to make choices about their own financial options. In the case of Regulation D, well within its regulatory authority, the SEC concluded that evaluating the merits and risks of a prospective investment requires financial and business acumen that most investors lack. As a result, the SEC issued regulations to require greater assurances that investors are informed before allowing them to participate in certain transactions. These transactions involve a specialized product – one that is unfamiliar to most investors and one that involves a high degree of risk. However, this does not necessarily support the notion that taxpayers should be prohibited by the IRS from allowing their own return information to be used to obtain a RAL or RAC.

The National Taxpayer Advocate notes that it is questionable whether RAL purchasers understand the terms of these products. However, federal and state banking and consumer protection laws governing the information that must be disclosed to taxpayers in such transactions have been in place for years. These laws apply to RALs as they do to other types of loan transactions. We expect the ANPR may provide more insight into this issue, but there is currently little substantive evidence to support a conclusion that the loan

disclosure rules that govern millions of other transactions are insufficient or that the risks inherent in the Regulation D regime are comparable to those involving RALs.

### **The ANPR Proposal May Do Little to Address the Perceived Problem**

Even if the arguments advanced in this Most Serious Problem are substantiated through reliable research, it is unclear whether the proposal contemplated in the ANPR will remedy the situation. The ANPR would attempt to separate the act of return preparation from the act of marketing specific products, such as RALs, to taxpayers. However, this may not be possible.

While return preparation services and RAL purchases are different transactions, they are inseparable. Taxpayers cannot obtain RALs without first getting their returns prepared and their refunds calculated. Thus, even if the return preparer is barred from any use or disclosure of the return information for this purpose, the person at the next desk will not be bound by this prohibition. For example, the “loan officer” could work with the preparer’s employer and occupy the same general office space as the return preparer. Indeed, taxpayers familiar with RALs are likely to expect such an arrangement, thereby compromising any perceived separation imposed by the ANPR.

It seems possible that the biggest impact from the ANPR regime is an increase in business costs – an increase that could affect the smallest tax return preparers most. In effect, the ANPR could potentially drive a consolidation in the return preparer marketplace – at least among those preparers serving taxpayers who obtain RALs.

### **More Research is Needed**

As previously noted, the IRS agrees that more research is needed in this area. Questions to be answered include:

1. Are tax preparers taking improper positions that cause inflated refunds?
2. If so, how widespread is the problem? Is it big enough to warrant concerted regulatory or enforcement actions?
3. What creates the incentive to engage in noncompliant behavior? Is this a problem specific to RALs and RACs or is it driven by the size of the refunds themselves? What other factors may play a role?
4. If action is needed, what can the IRS do to combat this problem? Does the IRS need additional authority to take action, or is the current regulatory scheme sufficient?

The IRS intends to conduct research into these questions and will consult with the National Taxpayer Advocate and other stakeholders to ensure all the relevant issues are addressed. This research, in combination with the feedback from the ANPR, will provide the fact-based information from which the IRS can draw reliable conclusions and make appropriate regulatory decisions.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate agrees with the IRS that more research data is necessary to establish the impact certain commercial products have on tax administration. As previously discussed, the National Taxpayer Advocate, members of Congress, and numerous stakeholders have repeatedly raised concerns related to RALs and other commercial products. Despite longstanding concerns, the IRS has failed to conduct any meaningful research to address the issue, yet at the same time continues to attempt to refute concerns by noting the absence of research data. It is encouraging that the IRS has finally agreed to conduct this long overdue research, which will allow all parties to base decisions on hard data rather than anecdotal evidence.

The IRS differentiates Regulation D by noting that it governs a specialized product that is unfamiliar to most investors and involves a high degree of risk. However, the National Taxpayer Advocate believes that these two characteristics are present in RALs and only lend credence to our analogy. Federal and state banking and consumer laws provide a degree of protection, but these laws are not under the purview of the IRS and do not, on their faces, dictate tax return preparer behavior. In addition, the state laws are inconsistent, providing federal taxpayers different levels of protection depending on where they live. Pursuant to such laws, taxpayers sign written disclosure forms, but nothing in the laws govern the preparers' behavior in presenting such forms for signature. Unless the IRS conducts research, it will never know whether taxpayers understand the terms of such forms and the consequences of signing them.

The IRS questions the feasibility of separating the act of return preparation from the purchase of a commercial product. The IRS notes that return preparation and RALs are inseparable because the purchase of a RAL is conditioned on the return preparation service. The response further contends the ANPR will merely create a new type of arrangement whereby the person at the desk next to the preparer will offer the taxpayer the RAL. However, adding one additional step, albeit trivial, will eliminate the current seamless process and will make clear to the taxpayer that the RAL purchase is not a part of the return preparation service and the IRS plays no role whatsoever in the transaction. Taxpayers who truly need RALs should be willing to take one additional trivial step to purchase the product.

In addition, the IRS notes that the proposed changes set forth in the ANPR would increase business costs to the preparer and potentially cause a consolidation in the preparer market. The IRS's statement inherently suggests preparers derive such a significant financial incentive to market RALs that the elimination of the incentive will cause them to reorganize their businesses. Moreover, if the suggested research finds commercial products increase preparer noncompliance and encourage taxpayer exploitation, the business costs of the preparers currently marketing RALs should be irrelevant.

Finally, the National Taxpayer Advocate finds the section of the IRS's response titled "The ANPR Proposal May Do Little to Address the Perceived Problem" disconcerting. Throughout the remaining sections of the response, the IRS repeatedly indicates its intent to perform research and consider public comments on issues raised in the ANPR. Yet, before any research is conducted or any comments are received, it publicly indicates in this section that it is opposed to the scheme proposed in the ANPR. By making such a statement, the IRS appears to undermine the public rule-making process.

## Recommendations

The National Taxpayer Advocate recommends that the IRS conduct research in conjunction with the Office of the Taxpayer Advocate to determine the impact certain commercial products have on tax compliance and taxpayer exploitation. The research should include, but is not limited to, the following items:

- The role commercial products play in retail preparer noncompliance;
- Whether the marketing of commercial products by preparers creates a financial incentive to inflate refunds or exploit taxpayers;
- Whether financial incentives received by preparers at the corporate level impact the behavior of preparers at the retail level;
- The resulting impact such marketing of commercial products by preparers has on tax administration and the public fisc;
- Options to address preparer noncompliance related to the marketing of commercial products; and
- Whether taxpayers understand the terms of the commercial products and can separate the act of purchasing the product from the return preparation process.

Further, the National Taxpayer Advocate recommends that the Department of Treasury and the IRS, after careful review of findings from the above-mentioned research and public comments, amend Treasury Regulation §301.7216-3 as set forth in the ANPR.

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## Identity Theft Procedures

### Responsible Official

Richard A. Spires, Deputy Commissioner for Operations Support

### Definition of The Problem

Identity theft is the number one consumer complaint in the United States, far outpacing all others. In 2006, the Federal Trade Commission (FTC) received 246,035 complaints of identity theft.<sup>1</sup> The FTC and other federal agencies have begun to mobilize to determine the scope of the problem.<sup>2</sup> The IRS encounters identity theft when an individual intentionally uses the Social Security number (SSN) of another person to file a false tax return or fraudulently obtain employment.

When identity theft victims have their tax accounts compromised, serious consequences arise, including:

- The delay or denial of refunds;
- The assessment of tax debts resulting from income reflected on the fraudulent filer's return; and
- The requirement for victims to prove their identity to the IRS year after year.

The IRS has a duty to these taxpayers to expeditiously determine the true owner of the SSN and restore the integrity of the affected taxpayer's account. While the IRS has recently taken steps to improve some of these processes, it too often exacerbates the difficulties these taxpayers experience by using procedures and systems that:

- Ignore common sense evidence as to whom the SSN belongs;
- Assign temporary IRS numbers (IRSNs) in lieu of the compromised SSNs for victims to use to file tax returns, then deny their tax benefits because they did not use SSNs; and
- Provide inadequate authentication processes for the electronic filing system.

<sup>1</sup> See FTC website, <http://www.ftc.gov/opa/2007/02/topcomplaints.shtm>. The next closest complaint was shop-at-home catalog sales with 46,995 complaints.

<sup>2</sup> See Exec. Order No. 13,402, 71 C.F.R. 27945 (2006) (establishing the President's Identity Theft Task Force, consisting of the Attorney General, Chairman of the FTC, and Secretaries of Treasury, Commerce, Health and Human Services, Veterans Affairs, and Homeland Security, Director of the Office of Management and Budget, Commissioner of Social Security, and other government officials).

## Analysis of The Problem

### Identity Theft in Tax Administration

Misuse of another person's SSN or identity generally occurs in tax administration in two contexts:

- The filing of a false return to obtain a fraudulent refund (refund fraud); or
- Proof of eligibility to obtain employment (employment-related fraud).<sup>3</sup>

According to FTC data, identity thefts related to refund fraud increased 396 percent from 2002 to 2006,<sup>4</sup> while the number of employment-related incidents has risen 129 percent in the same period.<sup>5</sup> As shown below in Table 1.6.1, Taxpayer Advocate Service (TAS) stolen identity cases have increased by 644 percent from fiscal year (FY) 2004 to FY 2007.<sup>6</sup>

**TABLE 1.6.1, TAS Stolen Identity, Mixed Entity And Scrambled SSN Cases FY 2004 to FY 2007**

	FY 2004	FY 2005	FY 2006	FY 2007
Stolen Identity	447 <sup>7</sup>	922	2,486	3,327
Mixed Entity	1,681	1,493	2,062	2,303
Scrambled SSN	786	1,063	1,107	858
<b>Total:</b>	<b>2,914</b>	<b>3,478</b>	<b>5,655</b>	<b>6,488</b>

Refund fraud through identity theft involves use of the personal information belonging to others, including the victim's name, SSN, and date of birth, to file false tax returns.<sup>8</sup> Typically, the perpetrators use false Forms W-2 (or increasingly, Schedules C) reflecting phantom wages and withholding credits, thus forming the basis of the fraudulent claim for a refund. The perpetrator will file returns early in the filing season before the lawful owner of the SSN has an opportunity to file. Filing the false return early is an essential element of the fraud because IRS data systems are designed to freeze any subsequent return using the same SSN (*i.e.*, the lawful return). To secure the fraudulent refund, the perpetrator typically will direct the IRS to electronically transmit the refund to a bank account under his or her control.

<sup>3</sup> See *Filing Your Taxes: An Ounce of Prevention Is Worth a Pound of Cure: Hearing Before the U.S. Senate Committee on Finance*, 110<sup>th</sup> Cong. (Apr. 12, 2007) (statement of Michael R. Phillips, Deputy Inspector General for Audit, Treasury Inspector General for Tax Administration).

<sup>4</sup> Federal Trade Commission Identity Theft Victim Complaint Data Figures and Trends, January 1 – December 31, 2002; Federal Trade Commission Consumer Fraud and Identity Theft Complaint Data, January 1 – December 31, 2006; see also *Filing Your Taxes: An Ounce of Prevention Is Worth a Pound of Cure: Hearing Before the U.S. Senate Committee on Finance*, 110<sup>th</sup> Cong. (Apr. 12, 2007) (statement of Michael R. Phillips, Deputy Inspector General for Audit, Treasury Inspector General for Tax Administration).

<sup>5</sup> Federal Trade Commission Identity Theft Victim Complaint Data Figures and Trends, January 1 – December 31, 2002; Federal Trade Commission Consumer Fraud and Identity Theft Complaint Data, January 1 – December 31, 2006; see also *Filing Your Taxes: An Ounce of Prevention Is Worth a Pound of Cure: Hearing Before the U.S. Senate Committee on Finance*, 110<sup>th</sup> Cong. (Apr. 12, 2007) (statement of Michael R. Phillips, Deputy Inspector General for Audit, Treasury Inspector General for Tax Administration).

<sup>6</sup> Taxpayer Advocate Management Information System, FY 2004, FY 2005, FY 2006, and FY 2007.

<sup>7</sup> TAS began tracking Stolen Identity cases in March 2004; annual total for 2004 is a 12-month estimate based on actual nine-month count of 335 cases.

<sup>8</sup> IRS, Electronic Tax Administration, information provided for this report (Sept. 13, 2007).



When the lawful SSN owner files a tax return, the negative tax consequences of the identity theft become apparent. The IRS's systems cannot interpret the duplicate filing as an identity theft situation and instead attribute the false wages to the innocent taxpayer, either reducing the innocent taxpayer's refund or creating a balance due. If a refund is due to the lawful SSN owner (even after taking into consideration the false wages), the IRS will freeze the lawful owner's refund claim without notifying the taxpayer that it has done so.<sup>9</sup> If there is a balance due as a result of two returns filed under the same SSN, the IRS will begin collection actions against the innocent taxpayer.<sup>10</sup> The IRS does not systemically notify the filer that a duplicate return has posted or that his or her refund has been frozen. Internal Revenue Manual (IRM) procedures indicate that the IRS contacts the taxpayer only as a last resort.<sup>11</sup> Sending the filers a "soft notice" questioning the validity of the second filing would involve the identity theft victim earlier in the process.

The negative tax consequences can be equally serious when those without the necessary legal status to gain employment in the United States unlawfully use another's SSN to obtain employment. The employer of the undocumented worker will file a Form W-2 reflecting the worker's wages, which IRS data systems will attribute to the rightful SSN owner. If the lawful owner has filed a tax return and received a refund, the Form W-2 will trigger a notice from the IRS's Automated Underreporter (AUR) unit to the lawful owner of the SSN, advising him or her of the unreported income. The IRS will assess a balance due unless the lawful owner of the SSN acts to halt the erroneous assessment. If the rightful owner is entitled to a refund, even after the false income is attributed, the refund will be frozen because the systems recognize that the SSN has been used twice.<sup>12</sup> If, after attribution of the false income, there is a balance due under the lawful SSN owner's account, IRS systems will begin collection action against this innocent taxpayer.

### IRS Procedural Response to Identity Theft Victims

Identity theft victims with federal tax problems may need to interact with multiple functions within the IRS, including Accounts Management, Criminal Investigation (CI), the Examination functions, and TAS. However, the IRS has no centralized function specializing in these cases, and the IRS's approach lacks consistency. The Accounts Management function has the primary responsibility for correcting accounts when SSN misuse is

<sup>9</sup> As we have pointed out in past Annual Reports to Congress, freezing a refund can be tantamount to denying the refund if the IRS takes no further action with respect to the claimed refund. See National Taxpayer Advocate 2005 Annual Report to Congress 25 (addressing Criminal Investigation's Questionable Refund Program). IRC § 6402(k) requires the IRS to notify taxpayers when it disallows a refund and provide the taxpayer an explanation for the denial.

<sup>10</sup> While there is an account freeze on refunds when there is a duplicate filing, there is no account freeze on collection actions against the innocent taxpayer. See IRM 21.5.6.4.2 (Feb. 5, 2007).

<sup>11</sup> IRM 21.2.4.4.37 (Oct. 1, 2007).

<sup>12</sup> See IRM 21.5.4.6.2 (Feb. 5, 2007). Even if the undocumented worker does not file a tax return to seek refund of his or her withholding credits, the innocent taxpayer will be affected because the undocumented worker's wages will be attributed to the innocent taxpayer.



present and there are multiple tax filings; however, other functions also either make adjustments or ask Accounts Management to do so.<sup>13</sup>

In response to multiple return filings using the same SSN, the IRS employs either “mixed entity” or “scrambled SSN” procedures.<sup>14</sup> The IRS uses mixed entity procedures when it knows which of the multiple SSN users is the correct owner.<sup>15</sup> Mixed entity procedures essentially consist of the IRS assigning a temporary IRS number (IRSN) to taxpayers wrongfully using the SSN, while the rightful SSN owner can continue using the number. The IRS then separates out the income attributable to the fraudulent filer from the innocent taxpayer’s account, transferring it to the IRSN.

The IRS initiates scrambled SSN procedures when it cannot determine the true owner of the SSN.<sup>16</sup> In this situation, it assigns IRSNs to *all* taxpayers using the SSN. Because certain tax benefits are conditioned upon the use of a valid tax identification number (TIN), taxpayers assigned the IRSN are denied those benefits because the IRS does not consider an IRSN to be a valid TIN.<sup>17</sup>

When a taxpayer whose SSN has been illegally used contacts the IRS about his or her tax problem (usually either a delay in a claimed refund or collection notices for income that was never earned), the taxpayer does not necessarily know that he or she has been a victim of identity theft. If the SSN misuse involved the filing of a fraudulent return, the IRS customer service representative will observe the duplicate filing in the account history and send Letter 239C, Scrambled SSN Clarification to Taxpayer, to each of the taxpayers using the SSN. This letter informs the recipient that another taxpayer has used the SSN in a tax filing and requests proof of the taxpayer’s identity.<sup>18</sup> At no point does the IRS representative attempt to contact the taxpayer by phone.

If none of the users of the SSN responds to the letter within 40 days, the IRS uses its scrambled SSN procedures. Previously, if one taxpayer responded to the letter while the other SSN user(s) did not, the IRS would use scrambled procedures unless the responding taxpayer could produce a Social Security Administration (SSA) verification letter within

<sup>13</sup> The Automated Underreporter (AUR) unit has the authority to close out an investigation if the taxpayer self-identifies as an identity theft victim, provides proof of the identity theft and provides proof of identity. See IRM 4.19.3.20.1.23 (June 25, 2007). TAS assists thousands of taxpayers every year with identity theft-related tax problems. See Table 1.6.1, *infra*. CI is also responsible for identity theft cases on which it has placed account freezes. See IRM 21.6.2.4.2 (Oct. 1, 2007).

<sup>14</sup> See IRM 21.6.2 (Oct. 1, 2007).

<sup>15</sup> See IRM 21.6.2.4.2 (Oct. 1, 2007).

<sup>16</sup> See *Id.*

<sup>17</sup> See IRC § 151(e) (requiring a valid TIN for the dependency exemption) and IRC § 32(c)(1)(F) (requiring valid TIN for the earned income tax credit). These sections require taxpayers to use a TIN on their returns to obtain the dependent exemption. Because Treasury Regulation § 301.6109-1(a)(1) does not specifically include an IRSN in the list of TINs (which include SSNs, individual identification numbers (ITINs) and employer identification numbers), the IRS denies these benefits to IRSN users until the taxpayer can prove that the SSN belongs to him or her. This verification process can take years. See Additional Legislative Recommendation, *Expand Definition of TIN to Include IRSNs*, *infra*.

<sup>18</sup> Letter 239C includes a questionnaire that inquires about the filer’s past use of the SSN.

40 days.<sup>19</sup> Under its new procedures, the IRS will accept validation of identity other than an SSA verification letter, including driver's license, passport, or Social Security card.<sup>20</sup> However, the taxpayer retains the burden of presenting evidence of identity theft to prevent the IRS from moving the victim under the scrambled procedures.<sup>21</sup> Evidence of identity theft includes an affidavit of identity theft filed with the FTC or a copy of a police report.<sup>22</sup> Once the IRS moves a case into scrambled procedures, it instructs the taxpayer to obtain an SSA verification letter to clear up the account.<sup>23</sup> The identity theft victim should be given the opportunity to present this information before the IRS scrambles the account. Scrambled procedures should be used as a last resort because they lead to the taxpayer being denied certain tax benefits, and can take years to resolve.

In October of 2007, the IRS posted substantially revised procedures for dealing with cases with TIN-related problems. Although TAS was a member of the IRS's Identity Theft Working Group when this effort was part of the Wage and Investment (W&I) Division, and resolves thousands of tax cases involving identity theft each year, TAS was not consulted when the IRS developed its new procedures.

### Lack of Continuity in IRS Approach

The National Taxpayer Advocate addressed problems with IRS procedures for dealing with identity theft in both the 2004 and 2005 Annual Reports to Congress, including the need for an account marker designating identity theft victims. This tool would prevent taxpayers from having to prove their identity to the IRS year after year.<sup>24</sup> In response to these reports and the concerns of other stakeholders,<sup>25</sup> the IRS created the Identity Theft Working Group led by W&I (which has oversight of the Accounts Management function). In October of 2006, the IRS transferred responsibility for the identity theft program to the Office of Privacy and Information Protection (OPIP) under the IRS's Mission Assurance and Security Services (Mission Assurance), but did not transfer any experienced identity theft staff to the Mission Assurance function.<sup>26</sup>

<sup>19</sup> The SSA requires taxpayers to make an appointment for a face-to-face meeting to obtain a verification letter. The process of making an appointment and obtaining the SSA verification letter can take months for even a diligent taxpayer to accomplish.

<sup>20</sup> See IRM 21.6.2.4.4 (Oct. 1, 2007).

<sup>21</sup> See Memorandum on Standard Identity Theft Documentation, Deputy Commissioner for Services and Enforcement, Kevin M. Brown (June 11, 2007).

<sup>22</sup> See Memorandum from Deputy Commissioner for Services and Enforcement, Kevin M. Brown, regarding Standard Identity Theft Documentation (June 11, 2007).

<sup>23</sup> See IRM 21.6.2.4.4 (Oct. 1, 2007).

<sup>24</sup> See National Taxpayer Advocate 2005 Annual Report to Congress 180-91 (addressing the unreasonable delay in resolving taxpayer problems, as well as problems with IRS procedures); National Taxpayer Advocate 2004 Annual Report to Congress 133-36 (addressing the inconsistent treatment of identity theft cases across the IRS).

<sup>25</sup> See Treasury Inspector General for Tax Administration, Ref. No. 2005-40-106, *A Corporate Strategy Is Key to Addressing the Growing Challenge of Identity Theft* (July 2005).

<sup>26</sup> The IRS indicated that it was taking this step so that it could take a corporate strategy to the identity theft problem. See *Filing Your Taxes: An Ounce of Prevention Is Worth a Pound of Cure: Hearing Before the U.S. Senate Committee on Finance*, 110<sup>th</sup> Cong. (Apr. 12, 2007) (statement of Michael R. Phillips, Deputy Inspector General for Audit, Treasury Inspector General for Tax Administration).

In an attempt to bring together all the IRS functions with responsibility for working identity theft problems, Mission Assurance planned an Identity Theft Summit to be held June 25-26, 2007. This Summit, to be led by Mission Assurance and TAS, was to provide a forum where various IRS functions identified obstacles in resolving the identity theft problem. A few days before the meeting, however, the IRS cancelled the Summit, moved OPIP out of Mission Assurance, and placed it under the Deputy Commissioner for Operations Support. While the IRS has taken positive steps, such as adopting the National Taxpayer Advocate's recommendation to use an electronic indicator on its master files to mark the accounts of taxpayers who have verified that they have been victims of identity theft,<sup>27</sup> there has not been enough emphasis on addressing processes that are unnecessarily burdensome to taxpayers.

### Concerns Identified by Local Taxpayer Advocates

In the face of TAS's growing identity theft caseload and as part of the Annual Report to Congress process, the National Taxpayer Advocate polled TAS's Local Taxpayer Advocates (LTAs) about problems with IRS procedures.<sup>28</sup> The most frequently voiced responses of the LTAs and analysis supporting their concerns follow.

LTA concern: *"The IRS puts too many taxpayers into its scrambled procedures unnecessarily. Scrambled procedures are burdensome on the innocent taxpayer and take too long to resolve."*

When innocent taxpayers contact the IRS for assistance with an identity theft-related problem, they unwittingly start the clock toward being moved into the IRS's scrambled SSN procedures (under which they will be denied use of their SSNs and suffer denied or delayed refunds). If the taxpayer cannot prove within the IRS's prescribed time limits that he or she lawfully owns the SSN, the IRS will move the case into its scrambled procedures. The IRS requires victims to present evidence of identity theft (either a copy of a police report or an FTC affidavit, plus government-issued identification<sup>29</sup>) to keep from being moved to scrambled procedures, and if moved, to obtain an SSA validation letter to clear the account.<sup>30</sup>

There are other instances in which IRS procedures ignore common sense evidence as to who owns the SSN. For example, the IRM instructs employees to never base a determination of SSN ownership on who has used the number the longest.<sup>31</sup> While there may be circumstances when the IRS should not rely upon use of the SSN, to disregard return filing history is to disregard important circumstantial evidence that can help taxpayers

<sup>27</sup> See National Taxpayer Advocate 2005 Annual Report to Congress 191.

<sup>28</sup> There are 75 LTA offices within TAS, with at least one LTA in each state, the District of Columbia, and Puerto Rico.

<sup>29</sup> See Memorandum on Standard Identity Theft Documentation Deputy Commissioner for Services and Enforcement, Kevin M. Brown (June 11, 2007); see also IRM 21.6.2.4.4 (Oct. 1, 2007).

<sup>30</sup> See IRM 21.6.2.4.4 (Oct. 1, 2007).

<sup>31</sup> See IRM 21.6.2.4.2.3 (Oct. 1, 2007).

demonstrate that they are identity theft victims.<sup>32</sup> Moreover, the IRS has tools to double-check this evidence. For example, the IRS has access to Social Security information housed on the Numeric Identification database (NUMIDENT) on its internal computer system. This database includes information from an individual's application for a Social Security card containing the individual's name, parent's name, date of birth, and place of birth. If a search of NUMIDENT reveals the SSN owner is a five-year old child, the IRS should be able to conclude that a taxpayer who has filed Forms W-2 for four years using this SSN is not the rightful owner.

IRS procedures also discourage the exercise of discretion on the part of some employees, creating an environment in which those who interact with taxpayers are the least able to assist them. IRS procedures prohibit Customer Service Representatives from taking action on mixed entity or scrambled SSN accounts.<sup>33</sup> Identity theft cases often are complex and require a certain skill level and specialized training. However, by not readily connecting the identity theft victim with the appropriate personnel to resolve the account issues, the IRS unduly lengthens the account resolution process and exacerbates the potential harm to the victim. Moreover, other functions within the IRS may be in the best position to determine the rightful SSN owner, but the strict rules prevent deviation from procedures. For example, the IRM instructs IRS personnel who are empowered to make account adjustments to disregard directions from the CI function, as follows:

Caution: Do not follow [Fraud Detection Center] instructions which deviate from established procedures.<sup>34</sup>

There are valid reasons to encourage employees to follow procedures. However, these procedures must allow for the exercise of discretion for functions that often interact with identity theft victims, such as Accounts Management, AUR, CI, Collection, and Examination. The complexity of the account work and the required employee skill level lend themselves to the establishment of a dedicated, centralized identity theft unit. With such a unit in place, the IRS would treat taxpayers more consistently and resolve accounts more promptly.

TAS case advocates frequently hear this complaint from their counterparts in other functions. A review of 25 randomly-selected TAS identity theft cases yielded the following responses from IRS employees, which were then recorded into the TAS case histories:

- "I can't take that action because mixed entity issues are not handled in the [Automated Collection System];"
- "The relief necessary is beyond my level of training;"

<sup>32</sup> IRS representatives describe cases in which SSNs assigned to individuals at birth are misappropriated by others and constitute a circumstance in which the length of use of the SSN is not trustworthy circumstantial evidence. However, for identity theft victims, a long track record of return filing is important circumstantial evidence to assist them in demonstrating their ownership of the SSN.

<sup>33</sup> IRM 21.6.2.4.2.1 (Oct. 1, 2007).

<sup>34</sup> IRM 21.6.2.4.3.1 (May 31, 2007).

- “I am not authorized in these matters;”
- “I am just not able to resolve this;”
- “I need higher authority;” and
- “The case has been worked as a mixed entity and the taxpayer has not received her refund so [we] decided to refer the case to TAS.”

LTA concern: *“There is still no IRS-wide strategy to deal with identity theft cases. Automated Underreporter, the Automated Collection System, Criminal Investigation, the Examination functions, the Taxpayer Advocate Service, and Accounts Management all have identity theft cases, but there is no coordinated effort, with cases worked differently in each function.”*

Identity theft victims may find themselves dealing with various functions of the IRS depending on the problem caused by the theft (*e.g.*, Accounts Management for duplicate filing, AUR for reporting of fraudulent income, or Collection for delinquent returns not filed or assessed taxes not paid due to the reporting of fraudulent income). The IRM sections belonging to the various functions dealing with identity theft cases do not cross reference one another, leaving taxpayers with inconsistent treatment. For example, false income from a fraudulent filer may be attributed to an innocent taxpayer in the AUR unit which then pursues the innocent taxpayer for taxes on the phantom income.<sup>35</sup> When the innocent taxpayer contacts the AUR unit to protest the attributed income that does not belong to him or her, the unit will close its open AUR investigation if the taxpayer self-identifies that he or she is the victim of identity theft and provides proof of identity and proof of identity theft (*e.g.*, a police report or an affidavit submitted to the FTC).<sup>36</sup>

An initial hurdle for taxpayers when contacting the AUR unit is that they may not know that the problem identified by AUR relates to identity theft. AUR procedures offer no guidance about researching an account to determine if the taxpayer may be a victim of identity theft or refer employees to the Accounts Management function, which under certain circumstances may need to become involved. The AUR unit has the authority to close an open investigation if the taxpayer provides all of the required information. However, there are no procedures within AUR to address post-assessment identity theft cases that involve mixed entity situations. In other words, the AUR unit might fix the problem if the taxpayer has enough information to claim identity theft victim status but the unit takes no action to address the larger problem (*i.e.*, that someone is using the taxpayer’s information to file a false return).<sup>37</sup>

The IRS’s identity theft procedures also fail to address different identity theft scenarios, and the lack of discretion afforded to IRS personnel brings problem resolution to a standstill, as demonstrated by the example below.

<sup>35</sup> For a full explanation of the AUR unit, as well as problems identified in the AUR, see Most Serious Problem, *Automated Underreporter*, *infra*.

<sup>36</sup> IRM 4.19.3.20.1.23 (June 25, 2007).

<sup>37</sup> See IRM 4.19.3.20.1.23 (June 25, 2007).

**EXAMPLE:** A taxpayer receiving Social Security disability benefits was notified by the SSA that her benefits were being terminated because the IRS had informed the SSA that she was earning income. The disabled taxpayer contested this fact but the SSA referred her back to the IRS. When she contacted the IRS, she was told there was self-employment income under her SSN indicating that she was working and had filed a tax return. The innocent taxpayer knew this was incorrect because she was not obligated to file a tax return and had not done so. She informed the IRS that someone was using her identity. The IRS told the taxpayer that it had no procedures to assist her. In this type of situation, TAS will work with the IRS to remove the false income information from the taxpayer's account, but would be hampered by the lack of IRM procedures to resolve this situation.

The changes made to the IRM effective October 1, 2007, do not adequately address these issues. The IRS needs to involve TAS (which sees the fallout from the lack of effective IRS procedures in its case work on a daily basis) when it revises its procedures.

LTA concern: *“Assignment of an IRSN should not automatically preclude tax benefits such as dependency exemption or the Earned Income Tax Credit.”*

The Internal Revenue Code requires taxpayers to provide a valid TIN to claim the dependency exemption and the earned income tax credit (EITC). Identity theft victims who file returns using IRSNs cannot claim these benefits because an IRSN is not a valid TIN.<sup>38</sup> Of course, taxpayers are using the IRSN solely because the IRS directed them to do so.<sup>39</sup> The policy of denying tax benefits such as the dependent exemption and the EITC to IRSN recipients in all cases defies logic and perpetuates the harm suffered by identity theft victims.

The denial of these tax benefits can turn a refund into a balance due account. As mentioned above, the IRS does not freeze collection actions in identity theft cases. Thus, in these cases, assigning the IRSN makes the identity theft victim's situation worse. Sometimes, the only action that can prevent an innocent taxpayer's SSN from being used year after year is to use scrambled SSN procedures, with IRSNs being assigned to all users of the SSN so the perpetrator cannot obtain the fraudulently claimed refund and will stop using the number. The IRS should either create a special numerical prefix on the IRSN for those taxpayers it knows to be the innocent victim or provide some other way for the true SSN owner to expediently obtain the tax benefits for which he or she is eligible.<sup>40</sup>

<sup>38</sup> See IRC § 151(e) (requiring a valid TIN for the dependency exemption) and IRC § 32(c)(1)(F) (requiring a valid TIN for the EITC).

<sup>39</sup> Letter 239C advises taxpayers:

You should use the Internal Revenue Service Number (IRSN) for federal income tax purposes until we can verify your social security number (SSN). Your IRSN is only a temporary number. We cannot allow you credits such as the Earned Income Tax Credit, etc., unless you have a valid taxpayer identification number. However, you should file your return on time and claim any credits.

<sup>40</sup> IRC §§ 151(e) and 32(c)(1)(F) require that a valid TIN be used on the tax return. The IRS could instruct IRSN recipients to reflect both the IRSN and the SSN on their tax returns so that IRC §§ 151(e) and 32(c)(1)(F) are satisfied. See Additional Legislative Recommendation: *Expand Definition of TIN to Include IRSNs, infra.*

LTA concern: *“Procedures for moving fraudulent information off of the taxpayer’s account take too long.”*

When it is necessary to move fraudulently-filed information off the innocent taxpayer’s account, the IRS uses a lengthy process to transfer the false return information to an IRSN assigned to the fraudulent filer. In certain cases, the IRS “zeroes out” the IRSN account (*i.e.*, the account assigned to the fraudulent filer), but not until it separates the accounts, which can take months.<sup>41</sup> It is not clear why the IRS undertakes these extra processing steps as opposed to simply “zeroing out” the fraudulently filed information as it does in other cases.<sup>42</sup> IRSNs are used in part to pursue erroneous refunds against perpetrators to whom refunds were paid; however, it unclear how effective the IRS is in pursuing these claims, if at all.<sup>43</sup> For example, the IRS does not know how many fraudulent refunds it pays out.<sup>44</sup> Moreover, identifying the perpetrators (who must use the taxpayers’ names and other information to penetrate the filing system) is nearly impossible for most functions within IRS, except the CI function.<sup>45</sup> If the inconvenience to taxpayers outweighs the benefits of the current IRSN procedures, the IRS should consider changing this process so innocent taxpayers are not made to wait while the IRS moves phantom income off its books.

LTA concern: *“There are insufficient protections in the electronic filing system to prevent identity theft.”*

Identity theft is possible because of weaknesses that have allowed fraudulent users of SSNs to penetrate the IRS’s filing and data systems. Current authentication protections are inadequate and some of the most effective security features are not mandatory for all filers. The IRS’s Electronic Filing System provides one example of how the security of filing systems can be improved. Taxpayers who file electronically can either use a tax professional designated by the IRS as an authorized Electronic Return Organization (ERO) or file their own returns using tax software. To authenticate returns, the IRS’s electronic filing system uses a predetermined set of personal tax return information that must be consistent with IRS data or the return will be automatically rejected. This authentication system applies to both EROs and those filing on their own computers. The IRS also has a personal identification number (PIN) process that adds an additional security feature, which makes it difficult for fraud perpetrators to breach. However, the PIN process is not mandatory for any electronic filers.<sup>46</sup>

<sup>41</sup> See IRM 21.6.2.4.3.5(1) (Oct. 1, 2005).

<sup>42</sup> The IRS simply zeroes out incorrect amounts in other contexts. For example, the AUR function zeroes out incorrect amounts when making adjustments. See IRM 4.19.3 (Sept. 1, 2007). The Automated Substitute for Return function also zeroes out incorrect amounts. See IRM 5.18.1 (Oct. 1, 2005).

<sup>43</sup> See IRM 21.6.2.4.4.9(6) (May 17, 2006); IRM 21.6.2.4.3.5 (May 17, 2006).

<sup>44</sup> Correspondence from Mark W. Everson, IRS Commissioner, dated June 6, 2007, to the Honorable Max Baucus, Chairman, Committee on Senate Finance, United States Senate.

<sup>45</sup> LTAs also complain that the CI function does not investigate referrals of identity theft cases unless those cases originate within the Questionable Refund Program. CI could play a vital role in these cases by assisting the IRS in identifying the perpetrators through investigation of bank accounts used to wire the fraudulent refunds.

<sup>46</sup> See IRM 3.0.273.15 (Jan. 1, 2007).



For a number of important reasons, the PIN process should be mandatory for all electronic filers. It would make electronic filing more secure and serve as an electronic signature. Electronic filers who do not elect to use the PIN must sign Form 8453-OL, *U.S. Individual Income Tax Declaration for an IRS Online e-file Return*, and mail it in to the IRS.<sup>47</sup> However, the IRS does not match the Forms 8453-OL before processing the returns. Thus, the IRS processes unsigned e-filed returns and issues refunds without ensuring that it has received and processed a signature document (the Form 8453-OL).<sup>48</sup>

Beginning in 2008, the PIN process will be mandatory for all EROs, but the IRS has no plans to impose the process on others out of concern that it will discourage electronic filing.<sup>49</sup> In a 2006 survey conducted by the IRS Oversight Board, over 70 percent of those surveyed did not feel secure sharing personal information over the Internet.<sup>50</sup> In another recent study conducted for the IRS by Russell Research, 72 percent of e-file users surveyed indicated they would prefer to use a self-selected PIN when electronically signing their return.<sup>51</sup> The National Taxpayer Advocate believes that additional security afforded by the PIN process outweighs any IRS concerns about public perception over inconvenience and should be a mandatory part of the electronic filing process.<sup>52</sup> Moreover, it is equally plausible that public confidence in electronic filing will increase if the PIN process becomes mandatory. The Treasury Inspector General for Tax Administration made a similar recommendation to the IRS in 2006, yet the IRS has refused to take such action, presumably out of fear that fewer taxpayers will file electronically.<sup>53</sup>

In addition to needing to improve filing security, the IRS must create proactive measures that allow identity theft victims to protect themselves. For example, the IRS does not allow taxpayers to “block” or “turn off” the electronic filing mechanism to discourage future electronic filings by potential identity thieves. The IRS recently created a code to identify and track identity theft accounts. The IRS should allow taxpayers the ability to request to have the code placed on their account, rather than only relying on IRS personnel to determine

<sup>47</sup> See IRM 3.42.5.16.2(2) (Oct. 1, 2006).

<sup>48</sup> See Treasury Inspector General for Tax Administration, Ref. No. 2006-30-160, *Requiring Personal Identification Numbers for Electronically Filed Returns Could Improve Tax Administration and Reduce Costs* (Sept. 20, 2006); Treasury Inspector General for Tax Administration, Ref. No. 2002-40-202, *The Internal Revenue Service Continues to Pay Refunds on e-Filed Tax Returns Prior to Ensuring a Signature Document Is Processed* (Sept. 27, 2002).

<sup>49</sup> See IRS, Electronic Tax Administration, information provided for this report (Sept. 13, 2007); see also Treasury Inspector General for Tax Administration, Ref. No. 2006-30-160, *Requiring Personal Identification Numbers for Electronically Filed Returns Could Improve Tax Administration and Reduce Costs* (Sept. 20, 2006). In the IRS Restructuring and Reform Act of 1998, Congress mandated that the IRS set a goal of achieving 80 percent of all federal tax returns and information returns being filed electronically. IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206 (1998), codified at IRC § 6011(f)(1) & (2). However, the IRS should not achieve this goal at the expense of security.

<sup>50</sup> IRS Oversight Board, *2006 Service Channels Survey*, Question 11. 70.2 – 76.2 percent do not feel secure sharing personal information over the Internet. Reasons include privacy concerns (33.4 – 40.8 percent) and Internet security issues (41.9 – 49.6 percent).

<sup>51</sup> Russell Research; *2007 Taxpayer Segmentation Study 32* (Apr. 9, 2007).

<sup>52</sup> See Treasury Inspector General for Tax Administration, Ref. No. 2006-30-160, *Requiring Personal Identification Numbers for Electronically Filed Returns Could Improve Tax Administration and Reduce Costs* (Sept. 20, 2006).

<sup>53</sup> See Treasury Inspector General for Tax Administration, Ref. No. 2006-30-160, *Requiring Personal Identification Numbers for Electronically Filed Returns Could Improve Tax Administration and Reduce Costs* (Sept. 20, 2006). The President’s Identity Theft Task Force also recommended that federal agencies need to improve authentication procedures to make it harder for identity thieves to access existing accounts. The President’s Identity Theft Task Force Summary of Interim Recommendations, Recommendation 5 (Sept. 19, 2006), available at: <http://www.idtheft.gov/about.html>.



when it is appropriate to apply it. While taking a few positive steps for taxpayers, the IRS has failed to act with appropriate urgency for the victims.

## Conclusion

The IRS has not done enough to improve identity theft procedures for victims of identity theft or to secure its filing system from fraudulent filers. The IRS's identity theft measures are reactive rather than proactive and assume taxpayers will have the wherewithal to contact the IRS and work their way through layers of employees until they reach someone with the authority to adjust the accounts. Too often, victims of identity theft receive more scrutiny from the IRS than the perpetrators of identity theft. The IRS should take a more taxpayer-centric approach to identity theft and put procedural changes on a fast track.

## IRS Comments

### Background

The IRS has always made the protection of taxpayer identity and the safeguarding of the sensitive information dealt with on a daily basis by its employees a top priority. As a result of the increased focus on privacy and identity theft issues over the past few years, the IRS has undertaken an aggressive strategy to reduce taxpayer burden and improve taxpayer treatment of identity theft in tax administration.

Recognizing the importance of an enterprise-wide approach to consistently address identity theft problems, the IRS recently established the Privacy, Information Protection, and Data Security (PIPDS) office under a Senior Executive to reach across all IRS organizations and ensure that proper attention and discipline is given to these important privacy, identity theft, and security issues. The Identity Theft and Incident Management (ITIM) office within PIPDS was created to focus on continuing the implementation of our corporate identity theft strategy and to coordinate efforts within the IRS to provide assistance and consistent treatment to taxpayers who are victims of identity theft.

The IRS generally encounters two primary types of identity theft that relate to tax administration: (1) the misreporting of income and (2) the filing of questionable tax returns generally claiming a refund.

- **Misreporting of Income** – The type of identity theft that relates to tax administration involves an individual using another person's name and SSN to obtain employment. Because income earned is reported to the IRS by the employer, it will appear to the IRS that the lawful taxpayer did not report all income on his or her tax return. These cases are primarily resolved by the Compliance function through the Automated Underreporter (AUR) program.
- **Questionable Tax Returns** – This second type involves an individual using another person's SSN to file a tax return in order to obtain a tax refund. These cases are

primarily resolved by the IRS Criminal Investigation Division, the investigative law enforcement arm of the IRS, and our Accounts Management function.

## Misreporting of Income

### Overview of the IRS's AUR Program

The AUR program matches information reported on information returns (*e.g.*, Form 1099 and Form W-2) submitted by third parties, such as banks, employers, and other payers against the information submitted by taxpayers on their individual income tax returns.

Identity theft cases are identified in the AUR program when the taxpayer self-identifies that he or she is a victim of identity theft after receiving a notice from the IRS that the taxpayer has not reported all income on the return, such as wages on Form W-2. The IRS will contact the taxpayer to request documentation to verify the taxpayer's identity and whether the wages or other income in dispute was received by the taxpayer. If the impacted taxpayer provides the IRS with the necessary documentation to verify his or her identity, the IRS will not assess additional tax.

### IRS Has Made Substantial Improvements to the AUR Program to Address Identity Theft

The IRS has updated its AUR process to provide assistance to victims whose identities have been stolen for employment purposes. The IRS has established new and consistent standards for the documentation for a taxpayer to verify his or her identity, which has resulted in a more efficient verification process. If the taxpayer provides the necessary documentation on an identity theft claim, the income in question will not result in an additional assessment, and the IRS can close the case. The IRS also shares this information with the Social Security Administration (SSA) to assist the taxpayer in correcting his or her total wages and Social Security taxes reported to the SSA. Additionally, in FY 2007, the AUR program developed an account indicator to exclude verified identity theft victims on multiple year cases when the income type was the same (*i.e.*, wages).

Beginning in 2008, the IRS will close all verified identity theft cases with a universal identity theft indicator that indicates the taxpayer self-verified as an identity theft victim. This universal identity theft indicator and the closing codes will be used as factors in the selection and prioritization of AUR cases in future years.

The IRS has a responsibility to protect the integrity of tax administration as well as to ensure that victims of identity theft receive proper and prompt treatment in resolving tax issues. We continue to look for opportunities to update our internal processes affected by identity theft, to reduce taxpayer burden, and to provide consistent treatment to identity theft victims. We will continue to work with key IRS business and operating divisions, including TAS, to develop and implement remediation strategies designed to address identified threats and vulnerabilities.

## Questionable Tax Returns

### Overview

In some identity theft cases, more than one taxpayer files a tax return using the same SSN but a different name. Because duplicate returns filed with a single SSN do not always involve identity theft, the IRS first tries to determine whether there is another reason for the duplicate filing (*e.g.*, transcription errors), a single taxpayer filing multiple returns for the same year to correct mistakes, or the most common cause, transposition errors by the taxpayer. If this is not the case, employees in our Accounts Management function make every effort to locate a correct SSN for the taxpayers and resolve the duplicate filing situation before contacting the taxpayers. Our research procedures outlined in the Internal Revenue Manual (IRM) include analyzing the information included in prior tax returns and accessing Social Security information contained in the SSA's Numeric Identification (NUMIDENT) database.

If Accounts Management is unable to definitively resolve the issue through research and contact with the taxpayers, the common number is “scrambled” and both taxpayers are assigned a temporary number (IRSN) to file future tax returns pursuant to IRS “Scrambled SSN” procedures. While we understand that the use of an IRSN may cause frustration to the legitimate owner of the SSN, in those cases in which we are unable to determine which taxpayer is entitled to use the SSN, we provide the taxpayer every opportunity to verify his or her identity by providing appropriate documentation before we apply Scrambled SSN procedures. We apply the Scrambled SSN process as a last resort when other evidence is not conclusive. This process protects the taxpayer and the integrity of tax administration by ensuring that the legitimate taxpayer's refund and tax information are not erroneously issued to an unauthorized party.

The Accounts Management procedures for researching and resolving questionable tax return cases are not the same as those used by Criminal Investigation (CI) for the investigation of duplicate returns identified in a refund scheme. The unique CI procedures are designed to identify the perpetrator of a refund scheme and distinguish the legitimate returns from those filed by the perpetrator in the attempt to carry out a refund crime.

### IRS Has Collaborated with the TAS and the SSA to Improve the Scrambled SSN Process

In October 2005 and January 2006, members of the TAS joined various other IRS representatives in working with the SSA on several process improvements to reduce taxpayer burden related to Scrambled SSN cases. These process changes included:

- Requiring the IRS to send Form 3857, Social Security Number Verification Request, to the SSA as soon as the IRS creates a scrambled SSN case. Previously, the IRS did not send Form 3857 to the SSA until we had completed all of our internal processing procedures;

- The improvement process requires the SSA to send the Form 3857 response back to the IRS as soon as it verifies the SSN owner. Previously, the SSA would complete all the SSA account actions before sending the Form 3857 response back to the IRS;
- Providing taxpayers with the option of securing a SSA Social Security Number Verification printout from the SSA. Previously, the SSA provided no documentation to taxpayers to verify they were the legitimate SSN owner; and
- Establishing a SSA acknowledgement process where the SSA acknowledges cases within 90 days of receipt so the IRS knows that the SSA has accepted the case.

Before October 2005, the average scrambled SSN case took approximately two years to resolve. As a result of the process improvements implemented by the IRS in collaboration with the SSA, the average scrambled SSN case resolution currently takes approximately ten months to resolve. Again, this process is a last resort and is used only in the most complex cases where neither taxpayer can provide adequate documentation of “true” identity.

Even with the recent improvements made to resolve identity theft cases, the IRS is committed to further improvements in our processes to better assist victims of identity theft and to resolve their issues more quickly. We are currently evaluating our scrambled SSN processes to identify additional opportunities to reduce the time required to resolve these cases and the burden imposed by them, and we continue to work closely with TAS to identify and implement future improvements. The IRS is also committed to providing additional training to our employees to ensure that they are adequately trained on IRS identity theft procedures and to make certain that they fully understand the procedures that are in place for referring cases when they are not able to resolve a particular identity theft issue.

### IRS'S Implementation of a Universal Identity Theft Indicator

The IRS understands the enormous burden placed on individuals who are the victims of identity theft, and we are working diligently to minimize this burden. In collaboration with the TAS and representatives from IRS business and operating divisions, the IRS has developed a process for using a universal identity theft indicator that will be placed on a taxpayer's account, beginning in 2008, when the taxpayer self-identifies as an identity theft victim. The universal identity theft indicator will reduce taxpayer burden by decreasing the time required to distinguish victim returns from fraudulent returns for refund-related instances of identity theft; and additionally, when fully deployed in future years, this indicator will be the key to creating a process by which taxpayers will only be required to provide the documentation to authenticate their identity one time.

Although taxpayers generally become victims of a single incident of tax-related identity theft through either the filing of fraudulent tax returns or the misreporting of income, in extraordinary cases, taxpayers may be the victims of multiple identity theft crimes, committed by multiple perpetrators, and/or affecting multiple tax years. When a taxpayer is affected by multiple identity theft crimes that require treatment by different IRS functions,

the IRM includes procedures for an assistor to refer taxpayers to the appropriate function. The new universal identity theft indicator will alert employees throughout the IRS that a taxpayer is a confirmed victim of identity theft and may have multiple tax administration issues. In this way, the indicator will enable the IRS to address identity theft cases in a more consistent and efficient manner and reduce taxpayer burden related to multiple IRS contacts.

The PIPDS office is working with impacted business units to provide guidance for developing consistent application of the identity theft indicator. As part of this effort, the ITIM office within PIPDS is reviewing business unit IRM guidelines, conducting one-on-one support sessions with business unit staff, and communicating with business unit executives.

### **IRS Efforts to Prevent Identity Theft**

In 2007, the IRS established an Identity Theft and Incident Management Advisory Committee, whose mission includes the development of Service-wide identity theft policies and procedures and the study and execution of identity theft outreach, victim assistance, and prevention initiatives. The Advisory Committee is comprised of members who represent key internal stakeholders, including TAS, the Offices of the Deputy Commissioner for Services and Enforcement and the Deputy Commissioner for Operations Support, Wage and Investment, Small Business/Self-Employed, CI, Communications & Liaison, and the Associate Chief Information Officer, Cybersecurity.

### **IRS Efforts for Future Victim Assistance Initiatives**

Some identity theft victims have unique and complex scenarios. As it is not possible to anticipate all possible circumstances involving victims, the ITIM office within PIPDS is collaborating with the TAS through weekly conference calls to discuss unique taxpayer cases. We will use this forum to develop proposals for process improvements that address these unusual cases.

### **IRS Efforts to Reduce or Eliminate the Use of Social Security Numbers**

Consistent with the Office of Management and Budget's (OMB) Memorandum M-07-16, dated May 22, 2007, the IRS has developed a plan for the elimination / reduction of the use of SSNs in tax administration, and is currently working to identify ways to eliminate/reduce the use of SSNs by IRS systems. Specifically, the IRS has compiled an inventory of all systems utilizing SSNs, issued a guidance memorandum on this process, and conducted interviews with impacted offices in an effort to create a plan for eliminating the use of SSNs where possible. The IRS is working closely with the SSA to ensure that IRS efforts to eliminate/reduce the use of SSNs are coordinated with similar efforts at the SSA.

### IRS Efforts to Inform Taxpayers about Identity Theft

The IRS has undertaken several outreach initiatives to provide taxpayers and employees with the information they need to proactively prevent and resolve identity theft issues. Some of these initiatives include:

- Launched an identity theft website on [irs.gov](http://irs.gov) to provide victims with updated information and links to the SSA and the Federal Trade Commission (FTC) and with information on how to contact the National Taxpayer Advocate;
- Participated with the Department of Treasury (Treasury) and the SSA in a multi-agency panel discussion on identity theft at the 2006 IRS nationwide forums that reached approximately 30,000 tax preparers;
- Led a multi-agency working group, including Treasury, the FTC, the SSA, and the Department of Homeland Security with a goal of providing consistent information and services to identity theft victims;
- Revised the most widely used tax documents, such as the Form 1040 instructions and Publication 17, *Your Federal Income Tax*, to include identity theft information;
- Developed an internal web communication tool to alert IRS employees to issues of identity theft; and
- Partnered with the Treasury Inspector General for Tax Administration to develop and promote a consistent message to inform taxpayers that the IRS does not initiate communications with taxpayers via e-mail.

### IRS Efforts to Improve Electronic Tax Administration

The IRS routinely evaluates its processes pertaining to Electronic Tax Administration (ETA). The Commissioner of the IRS Wage and Investment Division recently initiated a Working Group to evaluate the options the IRS will make available for taxpayers to electronically sign returns for Tax Year 2009. The Working Group will evaluate the feasibility of mandating the usage of a personal identification number process (PIN) by online filers for TY 2009. IRS management will analyze the impacts and risks of this proposal.

Additionally, ETA is exploring new ways to obtain electronic signatures and authenticators of taxpayer identity without making the process overly burdensome to taxpayers. ETA has initiated a survey that will help determine identification documents that are readily available to taxpayers to validate any new approaches to e-signatures and identity authentication.

### IRS Efforts to Provide Victim Notification of Potential Identity Theft

In accordance with OMB Memorandum M-07-16, the ITIM office within PIPDS, in collaboration with the Advisory Committee, has implemented an incident management and victim notification program to ensure appropriate handling of IRS losses of sensitive information that could potentially result in incidents of identity theft. The ITIM office has established

detailed procedures for assessing the risk of each loss of sensitive information and, based on this risk assessment, for sending notification letters to inform potentially impacted individuals of IRS data losses. In addition, the IRS is providing the notified individuals with free Equifax Gold credit monitoring services for one year. This package of services provides the best level of protection offered by Equifax and includes the monitoring of all three major credit reports, identity theft insurance, and 24/7 fraud victim assistance in the event an identity theft occurs. Finally, in collaboration with the TAS, the IRS is currently developing a notification process for taxpayers who have been identified by the IRS as identity theft victims related to a refund scheme. A pilot of this new notification process is scheduled to begin in early 2008.

### Conclusion

While the IRS recognizes that there is more work to be done to improve the policies, processes, and procedures for assisting identity theft victims, we have taken significant steps in the past few years to develop a more consistent, more efficient, and less burdensome manner for handling identity theft cases. Additionally, we are expanding the IRS identity theft strategy to address recommendations from the President's 2007 Identity Theft Task Force. We look forward to continuing to work with the National Taxpayer Advocate in order to identify, develop, and implement additional improvements in this important area of tax administration.

### Taxpayer Advocate Service Comments

We are pleased that the IRS recognizes identity theft as a serious problem and has made it a priority to address many of the concerns identified in this report. We acknowledge the improvements made by the IRS in resolving identity theft-related tax issues since the National Taxpayer Advocate first raised this concern in her 2005 Annual Report to Congress.

However, the National Taxpayer Advocate would like the IRS to take a more coordinated approach to resolving the identity theft problem. One way to achieve consistency is to create an IRM chapter devoted exclusively to resolving identity theft-related issues. Another way is to establish a dedicated unit of customer service representatives to help taxpayers resolve identity theft issues. We encourage the ITIM office to think about the best approach to provide assistance to identity theft victims.

The IRS identified 17 key programs that work with tax returns of individuals and thus have the potential to detect, deter, or respond to cases of identity theft.<sup>54</sup> With so many entry points, it is imperative that the ITIM office take a proactive role in ensuring that identity

<sup>54</sup> See IRS, *Identity Theft Program Current State*, dated July 20, 2007.



theft victims receive consistent treatment while dealing with the IRS to get their account problems resolved.

For example, we mentioned that the IRS recently created an identity theft tracking code that should enable it to track accounts which have been compromised, so taxpayers do not have to prove their identities to the IRS year after year. We regard this as a positive development, one that we have long advocated, but believe it is also important for the ITIM office to work with each of the various functions on how to utilize this tracking code. The ITIM office should not only be the driver in coordinating IRM revisions to ensure a consistent approach, but should give consideration to establishing firmer expectations for the functions to adhere to in establishing work procedures. TAS's concern with the current placement of the ITIM office in the IRS organization centers on the office's ability to be more than a "shell" when effecting changes that need to be made throughout the IRS functions that handle the account work impacted by identity theft. Because many of these functions reside in W&I, the ITIM office has no direct authority over them. We are concerned that the ITIM office will provide little more than "assistance," rather than direction or accountability, in ensuring that vital programs, such as the institution of the Identity Theft Indicator, are implemented effectively.

We also note that the IRS issued a Memorandum of Standard Identity Theft Documentation in June 2007, which provides for a list of acceptable documents that an individual could provide to the IRS to establish that he or she is a victim of identity theft. While we recognize the need for consistency, we hope this standardized approach does not replace common sense (*e.g.*, the IRS should not discourage the consideration of additional evidence provided by the individual). The National Taxpayer Advocate would like to work with the ITIM office to ensure that the functions revise their procedures to reflect this change.

A recurring scheme of tax fraud perpetrators is the use of electronic filing to commit refund fraud while utilizing direct deposit methodology to do so. As a direct result, the IRS has had to fight an uphill battle to recover fraudulent refunds issued to perpetrators. The IRS should take steps to provide additional security for refunds direct deposited to bank accounts. Accounts that receive a direct deposit of a refund are not required to be styled in the taxpayer's name, so the deposit is not rejected if the names of the account holder and the refund recipient do not match.

The National Taxpayer Advocate looks forward to continued collaboration with the IRS in the pursuit of process improvements for identity theft victims. We encourage the ITIM office to solicit input from the functions that deal directly with the account work to better understand the program vulnerabilities present and work collaboratively on the solutions needed to improve the identity theft program. In line with this goal, TAS also supports an Identity Theft Summit, much like the one that was scheduled for mid-2007, to



bring together all impacted functions to discuss their identity theft programs and needed improvements.

## Recommendations

The National Taxpayer Advocate recommends that the IRS take the following steps:

- The IRS should develop a dedicated, centralized unit to handle all identity theft cases, as well as a centralized IRM to house all identity theft procedures across the IRS. This IRM would provide various scenarios for account resolution.
- The IRS should develop a form that taxpayers can file when they believe they have been victims of identity theft. The instructions on the form should explain which steps the IRS will take and which steps the taxpayer should take (*e.g.*, obtaining an FTC affidavit) to restore the integrity of the taxpayer's account.
- The IRS should issue a soft notice to taxpayers whose refunds have been frozen because of a duplicate filing. A refund freeze can have the same effect as a refund denial if the taxpayer is unaware of the freeze or the reasons behind it.
- The IRS should also freeze collection actions when a duplicate filing is present until an investigation can determine the whether an identity theft has taken place.
- The IRS should eliminate Form 8453-OL from the electronic return process and make the PIN process mandatory because it will increase security, save money, and help eliminate taxpayer burden.<sup>55</sup>
- The IRS should also give identity theft victims the ability to take proactive measures such as blocking the e-filing option on their accounts.
- The IRS should create a prefix for IRSNs or some other system so that it does not deny tax benefits to the rightful owner of the SSN. While assignment of IRSNs may be the only way to isolate the fraud taking place under an SSN, it is inequitable to assign the IRSN to identity theft victims and then deny tax benefits that depend on the SSN.
- The IRS should plan an Identity Theft Summit in FY 2008 to bring together all IRS functions that deal with identity theft issues to discuss the problems in a collaborative effort.

<sup>55</sup> The IRS E-Signature Solution Working Group (in which TAS is a participant) is discussing eliminating this form (draft report of 8/29/2007). No specific plans are in place to eliminate the form and no decision has been made as to what will take its place.

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## Mortgage Verification

### Responsible Official

Richard J. Morgante, Commissioner, Wage and Investment Division

### Definition of Problem

When closing on a mortgage, borrowers often must consent to disclose certain tax information in order to verify their income. This consent usually involves signing a *blank* copy of Form 4506-T, Request for Transcript of Tax Return, which gives the lender access to four years of tax information for 60 days from the date on the form. However, the information disclosed is not subject to the same protection and limits on use as other taxpayer information, which raises numerous privacy concerns. As the IRS makes it easier for the private sector to access this information, the lack of taxpayer protection can lead to misuse or even the sale of confidential tax information. IRS forms should provide taxpayers the option of limiting the ways in which their tax information can be used.<sup>1</sup>

### Analysis of Problem

#### Limitations on Disclosure of Tax Information

The Internal Revenue Code (IRC) limits the disclosure of tax information.<sup>2</sup> In general, tax returns and return information cannot be disclosed unless expressly authorized by IRC § 6103. Section 6103(c) authorizes the Secretary to disclose, pursuant to regulations, tax information to any person designated by the taxpayers.<sup>3</sup> The regulations provide for nonwritten (oral) consents only in the tax context. Thus, the consents used for mortgages still must be in writing (electronic consents are deemed “written”).<sup>4</sup> Under the regulations, the taxpayer designates the party to whom his or her information should be disclosed by completing a request for or consent to disclosure, usually on Form 4506, Request for Copy of Tax Return, Form 4506-T, Request for Transcript of Tax Return or Form 8821, Tax Information Authorization.<sup>5</sup>

<sup>1</sup> This discussion is limited to administrative changes the IRS can make to protect taxpayer information. For a discussion of recommendations to change the Federal Tax Regulations, see Key Legislative Recommendation, *Consent-Based Disclosures of Tax Return Information Under Internal Revenue Code Section 6103(c)*, *infra*.

<sup>2</sup> The National Taxpayer Advocate has previously discussed the need to limit disclosure of tax returns and return information under IRC § 6103. National Taxpayer Advocate 2003 Annual Report to Congress 232-256.

<sup>3</sup> Treas. Reg. 301.6103(c)-1.

<sup>4</sup> *Id.*

<sup>5</sup> *Id.* This information, however, shall not be disclosed if the Secretary determines that “such disclosures would seriously impair Federal tax administration.” IRC § 6103(c).

Consent-based disclosure, however, raises significant privacy concerns. These disclosures may undermine the general privacy protection of IRC § 6103 because consent-based disclosures are not subject to use restrictions, *i.e.*, limitations on to whom and for what purpose specific pieces of tax information can be shared or re-disclosed. Once a taxpayer signs the consent form to disclose the tax information, there is no limit on how the information can be used. Moreover, consent-based disclosures are not subject to any of the statutory safeguards in place under IRC § 6103(p). Therefore, the IRS is not required to maintain a record or keep an accounting of disclosures made under IRC § 6103(c) or report on such disclosures to the Joint Committee on Taxation.<sup>6</sup>

### Mortgage Verification Process

One of the most common private sector uses of consent-based disclosure is for verification of a mortgage applicant's financial information, which forms the basis for granting a loan on real property. Many lenders require borrowers to complete Form 4506-T, Request for Transcript of Tax Return along with their other mortgage documents.<sup>7</sup> This form authorizes the lender or investor to obtain from the IRS copies of return transcripts, summarizing income and tax data, for as many as four years. The borrower must sign the form and the lender can only use it during the 60-day period following the date of signing.

In general, income verification is a good idea. From the lender's perspective, it ensures that the loan is granted on the basis of an accurate picture of a borrower's income, and thus protects lenders and borrowers from default. From the IRS's perspective, income verification may lead taxpayers to amend returns to include previously unreported income – which they reported to the lender to qualify for a loan – or help the IRS to identify instances of substantial underreporting or even tax evasion.

Lenders or closing agents often ask the borrower to sign a blank Form 4506-T at closing, without filling in the name of the party to whom the information will be disclosed, or without dating the consent.<sup>8</sup> This practice enables the lender to sell the loan in the secondary market, where a prospective buyer may verify the income of the mortgagee at that later time.<sup>9</sup> Many borrowers are also asked to sign, but not date the form – allowing lenders to use the form well outside the 60 days prescribed by the IRS.

<sup>6</sup> IRC § 6103(p).

<sup>7</sup> Form 4506, *Request for Copy of Tax Return* and Form 8821, *Tax Information Authorization* can also be used to provide consent-based disclosure.

<sup>8</sup> IRC § 6103(c) regulations require the IRS to receive consent within 60 days of its execution (presumably when signed and dated). The consent is valid until revoked. As a practical matter, however, consents designed for "single use" are only used in that manner (and the IRS does not save or enter them into systems to permit reliance at a later time).

<sup>9</sup> The National Taxpayer Advocate has received numerous reports that taxpayers have been placed in the situation of coerced consent – either sign the incomplete Form 4506 or 4506-T or not proceed with closing. For an example of coercive consents by a government agency, see *Tierney v. Schweiker*, 718 F.2d 499 (D.C. Cir. 1983) (holding that the Social Security Administration's consent form was likely to coerce individuals). The Joint Committee on Taxation notes that "[t]he coerced consents obtained in financial transactions from taxpayers (lenders won't make loans without verification of income) differ little from the consents invalidated in the Tierney case." Staff of the Joint Committee on Taxation, *Study of Present-Law Taxpayer Confidentiality and Disclosure Provisions as Required by Section 3802 of the Internal Revenue Service Restructuring and Reform Act of 1998*. Vol. I: Study of General Disclosure Provisions, JCS-1-00 (Jan. 28, 2000).

While these practices may make sense to mortgage lenders, they pose risks to the unaware or uninformed taxpayer. A taxpayer may not be aware that by signing an undated form on which the third party is not identified, the taxpayer's information may be obtained by any number of entities with access to that form, at any time in the future.

The IRS is making it easier for the private sector to obtain tax return information. Under the Income Verification Express Service (IVES), the IRS provides access to return transcripts within two business days.<sup>10</sup> Previously, lenders had to fax request forms to the IRS and wait for copies of returns or transcripts. Though requests still must be sent by fax, IVES provides the documents electronically in two working days at a cost of \$4.50 per transcript.<sup>11</sup>

The new service decreases turnaround time for companies that plan to use the information for non-tax purposes. However, taxpayers who request the same information for both tax and non-tax reasons are required to wait up to 30 days to receive the needed information.<sup>12</sup>

### Impact of Disclosure During Mortgage Verification

Under IRC § 6103(c), the use of tax information obtained by consent is not limited to the original purpose for which it was obtained. Thus, a mortgage company or other investor could use the information obtained by a § 6103(c) consent for purposes other than verifying the borrower's financial information. Current law provides no protection and requires no due diligence concerning whether mortgage lenders are actually filling in the forms or leaving them blank with regard to the date signed, who the information is provided to, and tax years required. Thus, these so-called "consent" forms can be used many times and a primary lender can pass the information to a secondary lender, even after 60 days when the consent should expire.

The ability of the private sector to obtain tax return information electronically may increase these risks. It is now easier for lenders, through a consent-based disclosure, to obtain taxpayer return information, creating the capacity for widespread use of taxpayer data obtained by "consent." The IRS's move to provide return information electronically also makes it easier to share this information with others.<sup>13</sup>

Moreover, the information taxpayers are "consenting" to disclose is not subject to the limitations and safeguards contained in the Code.<sup>14</sup> If the lender or other party discloses or

<sup>10</sup> IRS, *Income Verification Express Service (IVES)*, available at <http://www.irs.gov/individuals/article/0,,id=161649,00.html>.

<sup>11</sup> *Id.*

<sup>12</sup> One of the requirements for using the IVES system is enrollment in e-services. Individual taxpayers are not eligible to enroll in e-Services. For a detailed discussion of e-Services, see National Taxpayer Advocate 2005 Annual Report to Congress at 249259. For a detailed discussion of the problems taxpayers face in obtaining return transcripts, see Most Serious Problem, *Service At Taxpayer Assistance Centers*, *infra*.

<sup>13</sup> The IVES program is designed to be open to anyone. Once part of the IVES program, a private sector company such as a car dealership need only have a taxpayer sign a Form 4506-T. The company can then submit the completed form to the IRS and receive expedited access to tax return information for a small fee. At some point, the widespread dissemination of tax return data without sufficient safeguards undermines tax administration.

<sup>14</sup> IRC § 6103(p).

uses the information in a manner inconsistent with the purpose of the original consent, the Code's civil and criminal sanctions are not available.

### Protecting Taxpayer Information

Potential borrowers need to be aware of the dangers of signing blank Forms 4506-T and its counterparts. These forms should always be filled in completely before a borrower signs. Particularly, the name of the specific lender designated to receive the information, the specific information to be released, and the date should always be completed on any disclosure document.

Only signing completed forms can help prevent abuse of the system. In cases where borrowers are required to sign forms without dating them, the consent form can ultimately be used by a different lender who later purchases the mortgage to check the borrower's tax information. The result is that a lender other than the one originally granted consent can access data on up to four years of tax return information long after the IRS's 60 day limit. In fact, where the "tax year" information is not filled in on a signed but undated Form 4506-T, a lender can gain access to tax return information on an unlimited number of years. Of even greater concern is the potential to give unknown persons or entities access to confidential tax information which they could sell or misuse. Therefore, taxpayers should also be provided the option to specify on Form 4506-T and similar forms the purpose of their consent, thereby placing a limitation on how the information can be used.

The National Taxpayer Advocate previously recommended changes to IRC § 6103(c) to protect taxpayer information with respect to the mortgage verification process, and reiterates her recommendations in this year's report.<sup>15</sup> In an effort to educate taxpayers about the potential dangers of signing blank or incomplete forms, the new Taxpayer Advocate Service Tax Toolkit will contain two separate brochures discussing "Consumer Tax Tips" about mortgages and mortgage verification.<sup>16</sup>

TAS should not be the only organization to educate taxpayers on the importance of protecting confidential information. The IRS should revise Forms 4506, 4506-T and 8821 (and their instructions) to state in clear and plain language that taxpayers should not sign a blank or incomplete form. The IRS should also revise the forms to allow a taxpayer to specify the purpose for which the information he or she is consenting to disclose can be used by third parties. Further, the IRS needs to advise taxpayers of their privacy rights and the importance of not signing blank forms.

<sup>15</sup> See Additional Legislative Recommendation, *Consent-Based Disclosures of Tax Return Information Under IRC § 6103(c)*, *infra*. See also National Taxpayer Advocate 2003 Annual Report to Congress at 232-256.

<sup>16</sup> These TAS brochures will be available online at <http://www.tax-toolkit.com>.

## IRS Comments

### Background

The IRC provides taxpayers the right to request and gain access to their tax return information from the IRS. Generally, taxpayers or their authorized designees may request a copy of a tax return(s) by submitting Form 4506. They may also request a transcript of a tax return or tax return information by submitting Form 4506-T. To meet the needs of taxpayers, these forms allow for the designation of a third party to receive the taxpayer's return or transcript directly from the IRS. As these requests are processed, the IRS takes every measure to protect taxpayer privacy and to ensure the copy or transcript is provided only to the taxpayer or the designated third party in accordance with the taxpayer's request.

### Cautionary Language for Consent Forms

The IRS agrees with the National Taxpayer Advocate's comments regarding the need for cautionary language on these forms and has already provided such language. The current, April 2006, versions of both Forms 4506 and 4506-T contain multiple cautionary statements on the face of these forms. In the case of Form 4506, at the top of the form it says: "**Do not sign this form unless all applicable lines have been completed. Read the instructions on page 2** (emphasis supplied)." A second warning is included for those taxpayers who designate a third party to receive their information: "If the tax return is to be mailed to a third party (such as a mortgage company), enter the third party's name, address, and telephone number. The IRS has no control over what the third party does with the tax return." Offset for prominence in the middle of the form is a statement that again advises taxpayers: "*If a third party requires you to complete Form 4506, do not sign Form 4506 if lines 6 and 7 are blank* (italics and emphasis supplied)." Finally, instructions on page 2 of the form state: "**Signature and date** (emphasis supplied). Form 4506 must be signed and dated by the taxpayer listed on line 1a or 2a. If you completed line 5 requesting the return be sent to a third party, the IRS must receive Form 4506 within 60 days of the date signed by the taxpayer or it will be rejected." Identical information is included for Form 4506-T.

Form 8821, Tax Information Authorization, is used to authorize an appointee to inspect or receive confidential tax information in any office of the IRS for the type of tax and the years or periods listed by the taxpayer on the form. This form is not used to request transcripts or copies of tax returns and is generally not used by taxpayers for income verification purposes. However, because it permits the IRS to disclose tax information to designated third parties it will be revised to add similar, prominent, cautionary language about the need for taxpayers to sign, date, and fully complete the form.

### Limitations on Third Party Use

The National Taxpayer Advocate states that taxpayers should be provided the option to specify on Form 4506-T and similar forms the purpose of their consent, thereby placing a limitation on how the information can be used. However, as noted elsewhere in the

National Taxpayer Advocate's report, IRC § 6103(c) consent-based disclosures are not subject to third party use limitations and the civil and criminal sanctions of the Code do not generally apply. In addition, as a practical matter, it is beyond the jurisdiction or capabilities of the IRS to monitor the use of tax information disclosed for non-tax purposes once it has been received by a properly designated third party in accordance with the taxpayer's authorization.

### Methods of Obtaining Return Copies or Transcripts

Taxpayers can request free transcripts by calling 1-(800)-249-1040 or by mailing form 4506-T. Such requests are generally serviced in two weeks or less from the date the IRS receives the request. Requests for copies of tax returns must be mailed, there is a user fee of \$39.00 per tax year, and it can take up to 60 days to receive such copies from the IRS. IRS provides expedited transcript and return copy service, both free of charge, to disaster victims for use in obtaining federal disaster loans and related relief. Also, as noted in this year's IRS response to the Most Serious Problem: Service at Taxpayer Assistance Centers, we are revisiting our policy regarding the availability of transcripts at IRS walk-in assistance sites.

IVES provides two-business day processing and delivery of bulk return transcript requests. This service replaced the previous process that required manual pick-up and delivery of transcripts from the eight IRS Return and Income Verification Services (RAIVS) units located across the country. IVES automates the delivery portion of the process. Customers must now log on to IRS.gov to retrieve their requested transcripts from a secure mailbox located on the IRS e-Services electronic platform.

The IRS is not aware of any misuse of IVES by mortgage lenders or other authorized third party users. Nor do we agree this system lacks sufficient safeguards or that its use somehow serves to undermine tax administration, as postulated by the National Taxpayer Advocate in her report at footnote 13. Rather, the IRS developed this system to meet the large and long-standing demand for consent-based income verification disclosures, primarily for mortgage loan purposes. This system requires submission of taxpayer-signed, dated, and fully completed Forms 4506-T that include all the cautionary statements discussed above. The system allows the IRS to provide the requested information to a designated third party in a way that is fast, highly efficient, and extremely secure. Making the income verification process easier and faster provides a service that meets taxpayer needs and facilitates the purchase of millions of homes each year.

### Mortgage Closings

Most of the privacy concerns expressed by the National Taxpayer Advocate, including perceived coerced disclosure consents or that taxpayers are sometimes asked to sign blank disclosure forms, generally arise in the mortgage closing context. Regulation of such events, or the conduct of the lenders and closing attorneys involved, does not fall within



the jurisdiction of the IRS. However, we agree home purchasers and other borrowers need to understand the purpose of the forms they are asked to sign, they need to read them in their entirety, and in the case of IRS Forms 4506 and 4506-T, they need to consider the embedded cautionary statements discussed above.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS agrees with the need for cautionary language on Forms 4506, 4506-T and 8821. The National Taxpayer Advocate is especially pleased with the IRS's agreement to revise Form 8821 to include cautionary language about the need for taxpayers to sing, date, and fully complete the form. Although Forms 4506 and 4506-T contain a statement on the top of the form stating "Do not sign this form unless all applicable lines have been completed. Read the instructions on page 2", this language is insufficient.

A taxpayer may not know which lines are "applicable" to his or her situation when asked to sign the form. If a mortgage lender instructs the taxpayer to simply sign the blank form, the taxpayer has no indication that following the lender's direction may cause a problem. In addition, lenders may not provide taxpayers with instructions for the forms at the time they are asked to sign them. The cautionary language at the top of the form should be clear, plain, and in boldface type, and should strongly warn taxpayers **not** to sign the form unless it is completely filled in (and where appropriate, labeled "N/A"). The IRS could also strengthen the caution in the middle of the form by making the wording more noticeable to taxpayers. The IRS cannot assume taxpayers will have access to or be able to read the information in the instructions. The forms themselves must provide adequate warnings.

Although consent-based disclosures under § 6103(c) are not subject to third party use limitations, there is no reason that the IRS cannot attempt to curb improper use of taxpayer information. Amending Forms 4506, 4506-T and 8821 to allow taxpayers to specify the purposes for which they are giving consent may dissuade third parties from using the information for other purposes. The National Taxpayer Advocate is not asking the IRS to monitor the use of tax information disclosed for non-tax purposes. The National Taxpayer Advocate is asking the IRS to give taxpayers the option of trying to control the way in which their information is used by third parties.

The National Taxpayer Advocate is aware that the IRS cannot remedy many of the disclosure issues related to the mortgage verification process.<sup>17</sup> However, the IRS is part of the

<sup>17</sup> These are not "perceived" abuses, as the IRS calls them. Taxpayers have reported these issues to the National Taxpayer Advocate at town hall meetings, and the National Taxpayer Advocate herself was presented with a blank Form 4506 for her signature at three separate closings. On each occasion, she had to speak to senior loan officials at the lending institutions and inform them of IRS requirements before the closing could proceed. In fact, the attorney who conducted the closing had no knowledge of IRS rules and expressed surprise. It is reasonable to assume that taxpayers less familiar with IRS requirements would be unwilling to raise general concerns and thus jeopardize their loan closings.



process and therefore should make reasonable efforts to ensure that taxpayer information is not misused. By making simple changes to Forms 4506, 4506-T and 8821, as well as by engaging in outreach to taxpayers, the IRS can help fight the types of abuses plaguing taxpayers.

## Recommendations

The National Taxpayer Advocate recommends that the IRS:

- Revise Form 8821 and its instructions to state in clear and plain language that taxpayers should not sign a blank or incomplete form.
- Revise the cautionary language on Forms 4506 and 4506-T to state in clear and plain language that taxpayers should not sign a blank or incomplete form.
- Revise Forms 4506, 4506-T and 8821 to allow a taxpayer to specify the purpose for which the information he or she is consenting to disclose can be used by third parties.
- Engage in an outreach campaign to advise taxpayers of their privacy rights and the importance of not signing blank forms.

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## Transparency of the Office of Professional Responsibility

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### Responsible Official

Michael R. Chesman, Director, Office of Professional Responsibility

### Definition of the Problem

The IRS's Office of Professional Responsibility (OPR), which is charged with regulating tax practitioners, has not published sufficient guidance or procedures to assure the public that it operates fairly and independently. Unlike state bar associations, which are independent, OPR is a part of the IRS, which is often an adversary of the practitioner whose professional conduct it seeks to sanction. If there is any question about OPR's independence from the IRS, practitioners (and taxpayers) may fear that OPR will serve as an extension of the IRS enforcement function and arbitrarily target practitioners who are appropriately advocating for taxpayers. This belief would chill zealous advocacy by practitioners and harm taxpayers as well. Given OPR's location within the IRS, guidance that establishes reasonable limits on OPR's discretion would be particularly useful in establishing that it operates independently.

Despite recent progress in addressing these concerns, OPR can improve both the reality and perception of its independence by providing practitioners with a clear understanding of:

- What conduct is prohibited;
- How it follows up on referrals;
- How it will adjudicate an allegation (including policies governing practitioner access to information that could bear on the result); and
- What penalties it will seek for a given offense.

### Analysis of the Problem

#### Background

Given its power to reprimand, censure, suspend, and disbar practitioners from practice before the IRS, and to impose fines when they violate the rules of practice, which are known

as “Circular 230,”<sup>1</sup> OPR has enormous potential to address noncompliance that is facilitated by unscrupulous practitioners.<sup>2</sup>

Circular 230 historically prohibited unethical behavior without directly regulating tax opinions.<sup>3</sup> Since at least the early 1980s, however, both self-regulatory organizations and the government have sought to regulate them.<sup>4</sup>

Practitioners cannot just follow the ethical rules imposed by self-regulatory organizations, such as state bar associations, however, and assume that ethical behavior will keep them out of trouble with OPR. Circular 230 sometimes goes beyond what is required under prevailing ethical standards promulgated by state bar associations and other practitioner groups. For example, most practitioners now include a disclaimer on their email solely to prevent messages from inadvertently being treated as “covered opinions,” which are subject to extensive regulation under Circular 230.<sup>5</sup>

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- <sup>1</sup> See generally, Treasury Department Circular No. 230, *Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries, and Appraisers before the Internal Revenue Service*, 31 C.F.R. Subtitle A, Pt. 10 (June 20, 2005), as amended by 72 Fed. Reg. 54,621 (Sept. 26, 2007) (hereinafter, “Circular 230”).
- <sup>2</sup> Practitioners subject to regulation by OPR include: attorneys, certified public accountants, enrolled agents, enrolled retirement plan agents, enrolled actuaries and other persons representing taxpayers before the IRS. Circular 230 §§ 10.0, 10.3. Although many preparers are not currently subject to regulation by OPR, taxpayers are increasingly turning to all kinds of tax professionals for help, including those subject to Circular 230. About 62 percent of all returns were prepared by a paid tax preparer in 2005, up from about 58 percent in 2000. IRS, *Tax Year 2006 Taxpayer Usage Study*, Rpt. No. 15 (Aug. 24, 2007), available at <http://www.irs.gov/taxstats/article/0,,id=96629,00.html>; IRS, *Tax Year 2002 Taxpayer Usage Study*, Rpt. No. 14 (Aug. 30, 2002). Studies have suggested that “paid-prepared returns show relatively more compliance when line item ambiguity is low and relatively more non-compliance when line item ambiguity is high.” See Brian Erad, *Taxation with representation*, 52 J. Pub. Econ., 163, 166 (Sept. 1993) (summarizing prior studies).
- <sup>3</sup> Circular 230 has long required practitioners to: advise clients of omissions; exercise diligence as to accuracy of tax writings and representations; avoid working on matters in private practice that the practitioner personally and substantially worked on as a government employee; avoid unreasonably delaying matters; and avoid disreputable conduct such as certain violations of law, disbarment, giving false or misleading information to the IRS, false advertising with the intent to mislead, willfully failing to file a return, misappropriating client funds, improperly attempting to influence IRS officials, knowingly helping a person to practice before the IRS while ineligible to do so, and contemptuous conduct. See 31 C.F.R. §§ 10.21-10.26, 10.51, 31 Fed. Reg. 10,773 (Aug. 13, 1966). The American Jobs Creation Act of 2004 clarified the IRS’s authority to regulate certain tax opinions and the IRS subsequently revised Circular 230 to regulate “covered opinions.” See TD 9165, 69 Fed. Reg. 75,839, 75,839 (Dec. 20, 2004) (noting that the American Jobs Creation Act of 2004 “clarified” the Secretary’s authority to impose standards for written advice relating to a matter that is identified as having a potential for tax avoidance or evasion); H.R. Conf. Rept. No. 108-755, at 616 (2004) (characterizing the House bill as “clarifying” OPR’s authority).
- <sup>4</sup> See American Bar Association Formal Opinion 346 (Jan. 29, 1982); Rule 201 of the Rules of Conduct promulgated by the American Institute of Certified Public Accountants (AICPA), available at [https://www.aicpa.org/about/code/et\\_200.html](https://www.aicpa.org/about/code/et_200.html). According to the preamble of regulations proposed in 1982, “[T]he Treasury Department believes that a practitioner should not actively encourage potential tax shelter investors to pursue conduct which the practitioner believes is contrary to the tax laws.... Just as a lawyer has a duty to protect the integrity of the legal system as a whole, so the tax practitioner, in the Department’s view, has a duty to protect the integrity and effectiveness of the tax system.” Tax Shelters; Practice Before the Internal Revenue Service, 47 Fed. Reg. 56,144 (Dec. 15, 1982) (modified proposed regulations).
- <sup>5</sup> See Circular 230 § 10.35. Proposed changes to Circular 230 would also impose a higher standard than model ethical rules in connection with positions that can be taken on a return. Model ethical rules prohibit a practitioner from advising a client to take a return position unless it has a “realistic possibility” (i.e., a 33 percent chance) of being sustained, with certain exceptions. See ABA Committee on Ethics and Professional Responsibility, Formal Opinion 85-352 (July 7, 1985). Proposed changes to Circular 230, which were intended to conform Circular 230 with recent legislation applicable to preparer penalties, would subject a practitioner to discipline by OPR for signing a return containing an undisclosed position unless there was “a reasonable belief that the position would more likely than not be sustained on its merits.” Section 8246 of Pub. L. No. 110-28, 121 Stat 112 (May 25, 2007) (legislation codified at IRC § 6694(a)(2)(B) and applicable to returns prepared after May 25, 2007 adopting this “more likely than not” standard for purposes of preparer penalties); Notice of Proposed Rulemaking, 72 Fed. Reg. 54,621 (Sept. 26, 2007) (proposed changes to Circular 230 § 10.34). Another example of a disconnect between Circular 230 and model ethical rules is the requirement for practitioners to get a conflict waiver signed by a client within 30 days after the consent is received. Circular 230 § 10.29.

Nor can practitioners ignore Circular 230 based on the assumption that OPR's historic lack of enforcement will continue.<sup>6</sup> OPR has been expanding rapidly in recent years so that it can increase its enforcement efforts, as it should.<sup>7</sup>

IRS officials initially responded to calls for additional guidance by offering the advice that practitioners just use "common sense."<sup>8</sup> It remains to be seen how OPR will enforce these new rules. However, the top five reasons practitioners were sanctioned by OPR in fiscal year (FY) 2007 involved:

- Reciprocal actions involving loss of licensure or discipline by a state bar;
- Personal tax compliance problems;
- Issues involving a client's return;
- False and misleading statements; and
- Due diligence issues.<sup>9</sup>

### Benefits of Guidance and Transparency

#### *Transparency preserves OPR's independence from IRS enforcement functions.*

While practitioners need to follow ethical standards, taxpayers have a right to expect that their representatives will zealously advocate for their positions.<sup>10</sup> As a result, the IRS and practitioners are often opposing parties. If IRS enforcement personnel had the authority to take arbitrary disciplinary action against practitioners, practitioners could not be effective advocates and the process would break down. Any concerns about OPR's independence from the IRS enforcement functions could chill zealous advocacy by practitioners and

<sup>6</sup> The Treasury Inspector General for Tax Administration (TIGTA) reported that OPR enforcement actions increased from 73 in FY 2002 to 320 in FY 2005, largely as a result of OPR's expedited suspension procedure, which is generally used to discipline practitioners who have already been convicted or disbarred by another disciplinary body. See Treasury Inspector General for Tax Administration, Ref. No. 2006-10-066, *The Office of Professional Responsibility Can Do More to Effectively Identify and Act Against Incompetent and Disreputable Tax Practitioners* 4 (Mar. 2006), available at <http://www.treas.gov/tigta/auditreports/2006reports/200610066fr.pdf>. Enforcement actions declined to 310 in FY 2006 and then increased to 359 in FY 2007. Senior Counsel, OPR, Response to TAS information request (Oct. 12, 2007).

<sup>7</sup> In FY 2002, OPR had a budget of \$1.8 million and a staff of 15. Treasury Inspector General for Tax Administration, Ref. No. 2006-10-066, *The Office of Professional Responsibility Can Do More to Effectively Identify and Act Against Incompetent and Disreputable Tax Practitioners* 4 (Mar. 2006). As of October 2007, it had a budget of \$5.3 million and a staff of 58. Senior Counsel, OPR, Response to TAS information request (Oct. 12, 2007).

<sup>8</sup> See, e.g., Lee A. Sheppard, *Korb Won't Give In on Circular 230*, 109 Tax Notes 432 (Oct. 24, 2005) (quoting IRS Chief Counsel Donald Korb, as urging practitioners to use "common sense"); Sheryl Stratton, *IRS Rethinking Opinion Standards While Defending Transparency*, 110 Tax Notes 1143 (Mar. 13, 2006) (reporting that Cono Namorato, Director of OPR, advised practitioners to use "common sense" until the IRS can come out with additional guidance). See also Herbert N. Beller et al., *Lawyers, CPAs Urge Treasury, IRS to Revisit Circular 230 Rules*, 110 Tax Notes 661 (Feb. 6, 2006) (noting: "Given especially the current emphasis upon stronger enforcement of the tax laws, practitioner concerns in this sensitive area are not alleviated by unofficial remarks by government speakers at tax conferences, or by press reports of practitioner letters that purport to confirm views expressed during informal discussions with government officials. The stakes are simply too high for practitioners to assume that everything will be fine so long as they act in ways that comport with 'common sense' and 'reasonableness.'"); Kip Dellinger, *Circ. 230, Estate and Gift Practice: The Common Sense Approach*, 109 Tax Notes 1197, 1199 (Nov. 28, 2005) (noting that "representatives of the OPR have repeatedly admonished tax practitioners to use common sense in evaluating, vetting, applying, and implementing the written advice-covered opinion provisions of Circular 230").

<sup>9</sup> Senior Counsel, OPR, Response to TAS information request (Oct. 4, 2007) 347 of the 359 practitioners who were sanctioned by OPR in FY 2007 were sanctioned as a result of violations in one of these five categories. *Id.*; Senior Counsel, OPR, Response to TAS information request (Oct. 12, 2007).

<sup>10</sup> See ABA Model Rule 1.3 (comment), available at [http://www.abanet.org/cpr/mrpc/rule\\_1\\_3\\_comm.html](http://www.abanet.org/cpr/mrpc/rule_1_3_comm.html) (providing "[A] lawyer must also act with commitment and dedication to the interests of the client and with zeal in advocacy upon the client's behalf.").

harm taxpayers as well. Such concerns may be heightened by the fact that most OPR referrals have historically come from IRS employees rather than the public.<sup>11</sup>

*Transparency may reduce inadvertent violations.*

Given OPR's significant power to impose penalties, it should promulgate extensive guidance about how it will use this power.<sup>12</sup> Such guidance could help to ensure that practitioners do not inadvertently cross the line and know what to expect if they do.

*Transparency may reduce the tax gap.*

If practitioners do not understand their obligations, any intervention by OPR to enforce compliance may be perceived as unfair. Acting at all times with integrity, and in a manner perceived to be fair and reasonable, encourages voluntary compliance.<sup>13</sup> Thus, OPR may be more effective in getting practitioners to help the IRS address taxpayer compliance problems if it sets out clear rules and is viewed as enforcing them consistently, fairly, and without overreaching.

*Transparency reduces the potential for arbitrary enforcement.*

Additional transparency and guidance would also assure practitioners that OPR is handling any given case in accordance with its standard operating procedures. Although OPR has expanded in recent years, it still seeks sanctions against a relatively small number of practitioners – only 750 in FY 2006 and 1,069 in FY 2007.<sup>14</sup> While OPR might actually seek sanctions in only the most egregious cases, because so few practitioners are subject to any form of discipline by the OPR, its prosecution decisions may seem arbitrary.<sup>15</sup>

By analogy, it may be difficult for a police officer to show that he or she objectively determines who to ticket for speeding when many speeders are not ticketed. This perception of arbitrariness may be magnified if the speed limit is not posted and clearly visible. Similarly, OPR may be seen as singling out a few practitioners based on the personal preferences of OPR personnel (or IRS enforcement personnel), unless it clarifies the substantive

<sup>11</sup> According to TIGTA, most OPR referrals – 203 of the 227 referrals received between October 1, 1998 and December 8, 1999 – came from IRS employees because very little information about how to make a referral to OPR was available to the public. Treasury Inspector General for Tax Administration, Ref. No. 2001-10-027, *Improved Case Monitoring and Taxpayer Awareness Activities Can Enhance the Effectiveness of the Tax Practitioner Disciplinary Proceedings Program* 6 (Jan. 2001). Similarly in FY 2006, 67 percent (505 out of 750 referrals) came from IRS personnel. Senior Counsel, OPR, Response to TAS information request (Oct. 12, 2007). In FY 2007, however, only 47 percent (502 out of 1069) came from IRS personnel. *Id.*

<sup>12</sup> To its credit, the IRS has recently issued some guidance regarding how OPR will exercise its new authority to impose monetary penalties. Notice 2007-39, 2007-20 I.R.B. 1243.

<sup>13</sup> See, e.g., Organization for Economic Co-Operation and Development (OECD), Guidance Note, *Compliance Risk Management: Managing and Improving Tax Compliance* 70 (Oct. 2004); Joshua D. Rosenberg, *The Psychology of Taxes: Why They Drive Us Crazy, and How We Can Make Them Sane*, 16 Va. Tax Rev. 155, 172-189 (Fall 1996).

<sup>14</sup> Senior Counsel, OPR, Response to TAS information request (Oct. 12, 2007).

<sup>15</sup> More than half of all OPR cases are closed without sanction. Sixty percent (473 out of 783) were closed without sanction in FY 2006, and 56 percent (458 out of 817) were closed without a sanction in FY 2007. Senior Counsel, OPR, Response to TAS information request (Oct. 12, 2007).

rules under Circular 230 and publishes guidance and procedures for consistently eliciting and following up on referrals and determining what sanctions to seek.<sup>16</sup>

### *Transparency levels the playing field.*

A lack of transparency and published guidance may give former OPR employees and representatives who deal regularly with OPR a significant advantage, which could affect the outcome of the disciplinary process. For example, such practitioners would be aware of the outcomes in similar cases and unpublished internal practices, which would give them an advantage in negotiating with OPR. To the extent such knowledge is seen as helping certain practitioners negotiate lighter sanctions for their clients than other similarly situated persons, the disciplinary process may be regarded as inconsistent and unfair.

### *Transparency is required under existing rules.*

The Freedom of Information Act (FOIA) requires the IRS to make available to the public all “administrative staff manuals and instructions to staff that affect a member of the public.”<sup>17</sup> IRS policy goes even further, requiring *all* instructions to staff contained in job aids, desk guides, web sites, documents, or any other sources to be incorporated into the Internal Revenue Manual (IRM), which is available on the Internet in the IRS’s “electronic reading room.”<sup>18</sup> To the extent OPR has written down but not published its existing procedures, it may be violating these rules. If OPR fails to memorialize important procedures in writing, however, it cannot be sure its employees are handling cases consistently.

### **Both substantive and procedural rules could benefit from additional guidance and transparency.**

#### *Certain substantive rules applicable to practitioners need clarification.*

Some practitioners complain that Circular 230 includes a confusing set of substantive rules. For example, it may be difficult to determine whether written tax advice is subject to the “covered opinion” rules.<sup>19</sup> As noted above, most practitioners now include a disclaimer on every email message in hopes that it will prevent the email from being a covered opinion. Some practitioners are also uncertain about what constitutes “willful” conduct for purposes of Circular 230.<sup>20</sup> Others are uncertain about whether a statute of limitations applies to vio-

<sup>16</sup> Appropriate portions of such procedures could be classified as “official use only” and redacted to prevent practitioners from abusing OPR’s process. See 5 U.S.C. § 552(b)(7).

<sup>17</sup> 5 U.S.C. § 552(a)(2)(C). For additional discussion of the IRS’s challenges in this regard, see National Taxpayer Advocate, 2006 Annual Report to Congress 10 (Most Serious Problem: Transparency of the IRS).

<sup>18</sup> See IRM 1.11.2.2.2(1) (Apr. 1, 2007).

<sup>19</sup> See, e.g., *A Significant Problem Defining a ‘Significant Purpose’ and the Significant Difficulties that Result*, 111 Tax Notes 1119 (June 5, 2006); Sheryl Stratton, *Circular 230 Changes Fall Short of Expectations*, 2005 TNT 96-1 (May 19, 2005). See also, Mitchell Horowitz, Florida Bar Tax Section, *Florida Bar Tax Section Members Comment on Proposed Regs Modifying Circular 230*, 2006 TNT 79-25 (Apr. 25, 2006) (identifying a wide variety of substantive areas of uncertainty).

<sup>20</sup> Knowledge of the law is typically assumed. Where “willfulness” is an element of a tax crime, however, a good faith misunderstanding of the law may be a defense, even if the defendant’s misunderstanding of the law is not objectively reasonable. See *U.S. v. Pomponio*, 429 U.S. 10, 13 (1976); *Cheek v. U.S.*, 498 U.S. 192 (1991).

lations of Circular 230.<sup>21</sup> Still others are confused about what it means to “practice” before the IRS, which is important because “practice” is what Circular 230 purports to regulate.<sup>22</sup>

### *Certain procedures applicable to OPR proceedings need clarification.*

The National Taxpayer Advocate has also heard complaints that the IRS has not published clear procedural rules that allow practitioners to determine for themselves whether the IRS is following procedures in dealing with referrals and potential violations, how disciplinary proceedings will be conducted, how practitioners can obtain discovery, and whether OPR’s proposed sanction in a given case is reasonable and consistent with past practice.<sup>23</sup> Practitioner groups have expressed similar concerns.<sup>24</sup>

### Case selection and sanctions

OPR has not written down the analysis its employees use to determine which cases are worth pursuing or what sanctions are appropriate for a given offense.<sup>25</sup> According to the Treasury Inspector General for Tax Administration (TIGTA):

OPR does not have written procedures for how it controls and reviews referrals. OPR staff advised us that, because the program was small with minimal staff turnover, the process was verbally communicated among staff members. A draft desk guide for screening, controlling, and reviewing referrals was developed but never formalized or implemented.<sup>26</sup>

<sup>21</sup> See *Former IRS Officials, Treasury Official Disagree on OPR Limits*, 113 Tax Notes 717 (Nov. 20, 2006).

<sup>22</sup> See, e.g., Sam Young, *Key Definitions in IRS Practice Regs Remain Unclear*, 2007 TNT 213-6 (Nov. 2, 2007). If preparing a return is not “practice,” is preparing an offer in compromise or a collection information statement “practice”?

<sup>23</sup> One bedrock constitutional principle is the concept of proportionality, i.e., that any punishment should fit the offense and be applied consistently. In a criminal context, the Eighth Amendment prohibition on cruel and unusual punishment prohibits sentences that are disproportionate to the crime committed. See, e.g., *Solem v. Helm*, 463 U.S. 277 (1983); *Harmelin v. Michigan*, 501 U.S. 957 (1991) (questioning *Solem*, but recognizing limits on disproportionate sentences). In a civil context, courts also may strike down or reduce disproportionate punitive damages on due process grounds. See, e.g., *State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408 (2003).

<sup>24</sup> See, e.g., American Institute of Certified Public Accountants, *Comments on Proposed Regulations, REG-122380-02, Regarding Regulations Governing Practice before the Internal Revenue Service*, 8 (May 9, 2006), available at [http://tax.aicpa.org/NR/rdonlyres/15CA5651-D1C4-4785-826C-B46E-19BA0C57/0/Cir\\_230\\_Comments\\_Reg\\_12238002\\_final\\_5906.doc](http://tax.aicpa.org/NR/rdonlyres/15CA5651-D1C4-4785-826C-B46E-19BA0C57/0/Cir_230_Comments_Reg_12238002_final_5906.doc) (expressing concerns about the lack of checks and balances in OPR’s disciplinary system and recommending that IRS publish guidance regarding when IRS officials are to make referrals to OPR, how OPR is to handle the referrals, and how practitioners are to obtain information in OPR’s possession).

<sup>25</sup> Both the American Institute of Certified Public Accountants (AICPA) and TIGTA have expressed similar concerns. American Institute of Certified Public Accountants, *Comments on Proposed Regulations, REG-122380-02, Regarding Regulations Governing Practice before the Internal Revenue Service 2* (May 9, 2006); Treasury Inspector General for Tax Administration, Ref. No. 2006-10-066, *The Office of Professional Responsibility Can Do More to Effectively Identify and Act Against Incompetent and Disreputable Tax Practitioners 14* (Mar. 2006). The Director of OPR has recently been describing the general process at public meetings, however. See, e.g., Jeremiah Coder, *OPR Director Chesman Details Office to Allay Practitioner ‘Mistrust’*, 2007 TNT 191-5 (Oct. 2, 2007) (explaining “after reviewing the practitioner’s submitted explanation, the enforcement attorney prepares the case for a panel consisting of five enforcement attorneys who review the case and recommend a sanction. The practitioner is then contacted, and settlement negotiations are discussed.”). Oral comments do not, however, serve as an adequate substitute for written procedures.

<sup>26</sup> Treasury Inspector General for Tax Administration, Ref. No. 2006-10-066, *The Office of Professional Responsibility Can Do More to Effectively Identify and Act Against Incompetent and Disreputable Tax Practitioners 14* (Mar. 2006).



While OPR did not produce a copy of the draft desk guide in response to TAS's requests,<sup>27</sup> it did provide TAS with a description of the process.<sup>28</sup> Senior OPR officials initially voiced concern that if they created such a guide or manual and OPR employees did not follow it, practitioners could argue it created a "private right of action."<sup>29</sup> The National Taxpayer Advocate believes that OPR should incorporate the process into its public IRM, which can be redacted to the extent that publication of OPR's procedures would harm tax administration.

The IRS also has nothing akin to "sentencing guidelines" and few published examples of Circular 230 violations, the disciplinary process, or appropriate sanctions for a given offense.<sup>30</sup> Much of the public information about how OPR operates has come from articles written by former OPR employees or offhand remarks by IRS officials at conferences, which are sometimes reported in the press, rather than from guidance issued by OPR itself.<sup>31</sup> However, OPR has recently stated that it will draft sanction guidelines and incorporate them into its IRM.<sup>32</sup>

#### "Open file" discovery

Based on information published by the IRS, until recently it was unclear to some practitioners how they were supposed to obtain exculpatory evidence that might not be revealed in connection with a deposition.<sup>33</sup> A FOIA request might not be fulfilled in time for the

<sup>27</sup> Senior Management & Program Analyst, OPR Response to TAS information Request (Aug. 4, 2006); Senior Counsel, OPR, Response to TAS information request (June 19, 2007); Senior Counsel, OPR, Response to TAS information request (Aug. 10, 2007); Senior Counsel, OPR, Response to TAS information request (Aug. 10, 2007).

<sup>28</sup> Senior Counsel, OPR, Response to TAS information request (Sept. 19, 2007).

<sup>29</sup> TAS meeting with senior OPR officials (Aug. 9, 2007). However, agency manuals are not binding on the government. See, e.g., *The Wilderness Soc. v. Norton*, 434 F.3d 584 (2006). Moreover, by keeping its procedures secret, OPR could create a potential defense for practitioners. The Administrative Procedure Act requires each agency to publish various information, including "rules of procedure," in the Federal Register, and provides that "[E]xcept to the extent that a person has actual and timely notice of the terms thereof, a person may not in any manner be required to resort to, or be adversely affected by, a matter required to be published in the Federal Register and not so published." 5 USC § 552(a)(1). It further provides that "[A] final order, opinion, statement of policy, interpretation, or staff manual or instruction that affects a member of the public may be relied on, used, or cited as precedent by an agency against a party other than an agency only if – (i) it has been indexed and either made available or published as provided by this paragraph; or (ii) the party has actual and timely notice of the terms thereof." 5 USC § 552(a)(2). Since our initial meeting, OPR has responded that it is generally working to update its IRMs to provide more transparency, but did not describe the specific nature of the changes. Senior Counsel, OPR, Response to TAS information request (Oct. 12, 2007).

<sup>30</sup> In 1997 the IRS published a few hypothetical examples. See Scenarios of Disciplinary Actions From the Office of Director of Practice, 1997-1 C.B. 827, 1997 IRB LEXIS 1612 (Jan. 1997). They do not, however, address the more controversial issues that have surfaced in recent years, such as cases involving "covered opinions."

<sup>31</sup> One former OPR attorney recently described the process as taking a "broad set of factors" into account, including: the "nature and severity" of the conduct, whether there has been a "pattern of conduct," prior "disciplinary history," "aggravating and mitigating factors," and the "effect on the confidence of the practitioner community as a whole." See Kevin E. Thorn, *A Rare Look Inside the IRS's Office of Professional Responsibility*, *The Professional Lawyer* 18, 21 (2007). These considerations would be more helpful if they were published by OPR, rather than a former OPR employee, along with specific examples and benchmarks.

<sup>32</sup> Senior Counsel, OPR, Response to TAS information request (Oct. 4, 2007).

<sup>33</sup> IRS officials made public remarks about OPR's "open file discovery" policy, but it was not otherwise included in the IRM or other guidance, prior to September 2007, as discussed below. Sheryl Stratton, *IRS Intent on Transparency in Disciplinary Proceedings*, *OPR Director Says*, 2007 TNT 48-8 (Mar. 12, 2007) (reporting on statements by IRS officials that "OPR's position is to share any disclosable information on which the allegation is based").

hearing. In addition, the current regulations do not expressly say that a practitioner can make requests for admissions.<sup>34</sup>

Although the rule of procedural due process that requires criminal prosecutors to disclose exculpatory evidence may not apply to disciplinary proceedings brought by OPR, it would be inappropriate for OPR to withhold such evidence from a respondent.<sup>35</sup> In similar proceedings before the Treasury Department and the Securities and Exchange Commission (SEC), federal regulations expressly provide a form of “open file” discovery and require the disclosure of exculpatory evidence.<sup>36</sup>

OPR’s formerly unwritten “open file” discovery practice was publicly unveiled in the preamble to the September 2007 revisions to Circular 230, which provides:

Although not formalized in the regulations or the Internal Revenue Manual currently, the current practice of the Office of Professional Responsibility is to provide to the respondent upon request a copy of what informally is understood as the “OPR administrative file” ... The Treasury Department and IRS intend for the practice of releasing the OPR administrative file upon request to continue. This practice addresses in part commentators’ concern that documents included in the investigatory file, including releasable exculpatory evidence, be provided to the respondent. The IRS expects to issue Internal Revenue Manual provisions in the near future pertaining to the Office of Professional Responsibility’s procedures for investigations. It is expected that those provisions will formalize the definition of the OPR administrative file and the current practice of providing it to the respondent upon request. ...the Treasury Department and IRS are considering ways in which the existing practice relating to the OPR administrative file can be formalized, and will consider addressing this issue in future published guidance.<sup>37</sup>

We are pleased that OPR is working to incorporate this policy into an IRM. However, the IRS controls the content of the IRM, and unlike a regulation, the IRS can easily change it without public comment. Moreover, the open file discovery procedures should be

<sup>34</sup> Circular 230 § 10.72(a)(3)(ii) provides, in relevant part, that hearings will be conducted pursuant to 5 U.S.C. § 556 (the Administrative Procedure Act (APA)). According to the APA: “A party is entitled to present his case or defense by oral or documentary evidence, to submit rebuttal evidence, and to conduct such cross-examination as may be required for a full and true disclosure of the facts.” 5 U.S.C. § 556(d). Specifics are left to the agencies. Circular 230 § 10.63(d) requires the IRS to provide evidence in support of the complaint to the respondent. However, it does not require the IRS to provide exculpatory evidence to the respondent.

<sup>35</sup> See *Brady v. Maryland*, 373 U.S. 83, 83 S.Ct. 1194 (1963) (establishing the due process right of criminal defendants to receive exculpatory evidence).

<sup>36</sup> See 17 C.F.R. §§ 201.230 (requiring the SEC to provide for open file discovery, except with respect to certain documents with the proviso that “[N]othing... authorizes the Division of Enforcement ...to withhold, contrary to the doctrine of *Brady v. Maryland*, 373 U.S. 83, 87 (1963), documents that contain material exculpatory evidence.”); 31 C.F.R. § 501.723-724 (requiring the Treasury Department to provide open file discovery, including exculpatory evidence, to persons accused of violating the Trading with the Enemy Act). Federal regulations also require the Department of Labor to provide exculpatory evidence to employers accused of Occupational Safety and Health Act (OSHA) violations. 29 C.F.R. § 2200.206.

<sup>37</sup> See T.D. 9358, 72 Fed. Reg. 54,540, 54,543 (Sept. 26, 2007). However, a former OPR attorney has cautioned that OPR “has the discretion to honor or deny the request.” See Kevin E. Thorn, *A Rare Look Inside the IRS’s Office of Professional Responsibility*, *The Professional Lawyer* 18, 21 (2007).

incorporated into in Circular 230 where most other discovery procedures are located so as to avoid giving the impression that they can be ignored as less important than others.

**The Circular 230 advisory committee could help OPR provide additional guidance but it may not be composed of the most qualified individuals because members were not selected using an open process.**

Circular 230 has long authorized the IRS to establish one or more advisory committees, made up of five or more practitioners, to develop hypothetical examples which could serve to provide both substantive and procedural guidance.<sup>38</sup> We are pleased that OPR has recently created an advisory committee for this purpose.<sup>39</sup> As of this writing, however, the committee has not produced any such guidance. Moreover, the National Taxpayer Advocate is concerned that OPR's advisory committee is a subcommittee of the IRS's Information Reporting Program Advisory Committee (IRPAC) rather than a stand-alone committee.<sup>40</sup> According to the IRPAC's charter:

The primary purpose of the Advisory Committee is to provide an organized public forum for discussion of *relevant information reporting issues* of mutual concern as between Internal Revenue Service ('IRS') officials and representatives of the public. (emphasis added).<sup>41</sup>

In its latest report, IRPAC only discussed information reporting issues such as: expanding access to a tax transcript delivery system, increasing the electronic delivery of certain notices, and changing a publication that describes how to report interest on certain debt instruments.<sup>42</sup> The IRS clearly articulated IRPAC's focus on information reporting when the IRS recently sought nominations for new IRPAC members.<sup>43</sup> Although we understand that the IRS informally solicited applications from members of various practitioner organizations for the OPR subcommittee, *it did not give all parties who might be interested in serving on OPR's advisory committee an opportunity to seek membership.*<sup>44</sup> As a result, other individuals may be better qualified with respect to Circular 230 issues.<sup>45</sup> OPR should ensure that its

<sup>38</sup> According to Circular 230 § 10.38, "an advisory committee may review and make general recommendations regarding professional standards or best practices for tax advisors, including whether hypothetical conduct would give rise to a violation of §§ 10.35 or 10.36."

<sup>39</sup> Jeremiah Coder, *OPR Director Chesman Details Office to Allay Practitioner 'Mistrust'*, 2007 TNT 191-5 (Oct. 2, 2007) (stating: "Chesman also reported that he has created an advisory board under the IRS's Information Reporting Program Advisory Committee (IRPAC) to provide better guidance to practitioners on day-to-day best practices. The board will pose hypothetical questions about which OPR will give advice, thus getting around the section 6103 problem of using past cases as examples").

<sup>40</sup> Senior Counsel, OPR, Response to TAS information request (Oct. 12, 2007).

<sup>41</sup> Information Reporting Program Advisory Committee; Renewal of Charter, 70 Fed. Reg. 57,925 (Oct. 4, 2005) (renewing the charter for a two-year period beginning November 4, 2005).

<sup>42</sup> Information Reporting Program Advisory Committee, General Report (Nov. 16, 2006), available at [http://www.irs.gov/pub/irs-utl/2006\\_irpac\\_public\\_meeting.pdf](http://www.irs.gov/pub/irs-utl/2006_irpac_public_meeting.pdf).

<sup>43</sup> Information Reporting Program Advisory Committee; Nominations, 72 Fed. Reg. 15,760, 15,761 (Apr. 2, 2007).

<sup>44</sup> The non-public method used by the IRS to solicit members of the OPR subcommittee may also appear to validate public concerns about OPR's transparency.

<sup>45</sup> For biographies of the current IRPAC members, see [http://www.irs.gov/pub/irs-utl/2007\\_irpac\\_bios\\_\\_2\\_.pdf](http://www.irs.gov/pub/irs-utl/2007_irpac_bios__2_.pdf).

advisory committee gives qualified individuals who have represented practitioners before OPR an opportunity to serve on a stand-alone committee dedicated to Circular 230 issues.

**Publishing agency reports and decisions will provide additional transparency, but is no substitute for published guidance and procedures.**

In 2006, the IRS proposed modifications to Circular 230 that would provide additional guidance and transparency by immediately publishing all pleadings, evidence, reports, decisions, appeals, briefs, responses, and the final decision.<sup>46</sup> Such transparency would have shown the public the type of behavior OPR was pursuing, and publicly identify potentially abusive practitioners, possibly serving to protect the public.<sup>47</sup> While transparency could also reduce the potential for abuse of prosecutorial discretion by OPR, at least one worried practitioner group commented:

the ability to make disciplinary proceedings public at such an early phase in the process may present an irresistible temptation to use the specter of bad publicity as a tool to improperly manipulate the process by pressuring (directly or indirectly) accused practitioners into settlement. The influence of such an adverse incentive is difficult to monitor successfully and certainly would not be transparent to the general practitioner community.<sup>48</sup>

Moreover, the National Taxpayer Advocate expressed the concern that making disciplinary proceedings public before the IRS has reached a final determination could unnecessarily tarnish the reputations of innocent practitioners, especially since OPR resolves most of its cases without any sanction.<sup>49</sup> Based on these comments and others, the final regulations provide for public disclosure of all reports and decisions of the agency only after the disciplinary decision becomes final.<sup>50</sup> While publishing reports and decisions provides a certain amount of transparency on a case by case basis, even if practitioners can obtain some such information from the reports and decisions, they will not be able to identify OPR's current procedures. Further, because some of its procedures are not written down and available to the public, OPR could change them without notice. Thus, published reports and decisions do not eliminate the need for published guidance and procedures.

<sup>46</sup> Proposed Circular 230, 71 Fed. Reg. 6421 §§ 10.72(d) and 10.77(a)(2) (Feb. 8, 2006).

<sup>47</sup> It would also allow AICPA and other organization that have automatic sanctions which are triggered by OPR sanctions to be able to apply those sanctions without asking the practitioner why he or she was sanctioned by OPR. See AICPA, Joint Ethics Enforcement Program (JEEP), Manual of Procedures § 7.3.2.2 (Dec. 2006), available at [http://www.aicpa.org/NR/rdonlyres/4E2729C5-6B1A-47A5-9D57-64D8CBDEDE6F/0/Dec\\_2006\\_JEEP\\_Manual.pdf](http://www.aicpa.org/NR/rdonlyres/4E2729C5-6B1A-47A5-9D57-64D8CBDEDE6F/0/Dec_2006_JEEP_Manual.pdf).

<sup>48</sup> See American Institute of Certified Public Accountants, *Comments on Proposed Regulations, REG-122380-02, Regarding Regulations Governing Practice before the Internal Revenue Service* 8 (May 9, 2006).

<sup>49</sup> Memorandum from National Taxpayer Advocate to Associate Chief Counsel (Procedure & Administration), *National Taxpayer Advocate Comments to Selected Sections of Circular 230* (Apr. 12, 2007). As noted above, 60 percent (473 out of 783) were closed without sanction in FY 2006, and 56 percent (458 out of 817) were closed without a sanction in FY 2007. Senior Counsel, OPR, Response to TAS information request (Oct. 12, 2007).

<sup>50</sup> Circular 230 § 10.72(d)(1).

## Conclusion

OPR has recently made progress in improving its transparency and accountability by working to incorporate more of its procedures into its IRM, disclosing its open file discovery practice to the public, and establishing an advisory committee to provide additional guidance. However, it should expedite efforts to publish sanction guidelines and hypothetical examples. It should publish guidance regarding the substantive rules and important procedural rights, such as the right to exculpatory evidence and open file discovery, using the regulation process as other agencies have done. OPR should also establish a free-standing advisory committee so that a diverse array of tax professionals, including those with experience defending practitioners in proceedings against OPR, has an opportunity to serve.

## IRS Comments

The National Taxpayer Advocate states that OPR has not published sufficient guidance or procedures to assure the public that it operates fairly and independently. It does not follow that OPR is not operating fairly and independently. A perspective on where OPR has been, and how far we have come, is helpful to understanding how OPR administers its programs fairly, independently, and with integrity.

The office was known until 2002 as the Office of the Director of Practice. At the height of the tax shelter wars, former Commissioner Everson saw an opportunity for the office to become a real enforcement tool in combating tax schemes by sanctioning the individuals who promote them. The office was renamed and has undergone a three-fold increase in staffing in order to better combat ethical abuses by practitioners.

Fully staffed, OPR now has 58 employees. The majority of the employees are housed in the IRS National Headquarters and there is a smaller component in Detroit. In Headquarters there is a Case Development and Licensure Branch and an Enforcement Division divided into two Enforcement branches. This three-fold increase has presented challenges in terms of developing new operations and procedures to manage the increased work load. Nonetheless, the reinvigoration of OPR has paid off: In FY 2002, OPR resolved 221 cases against practitioners; in FY 2007 we resolved 1102 cases against practitioners.

Structurally, OPR is part of the Treasury Department, not a part of the IRS. OPR administratively reports to the IRS Commissioner. OPR partners with, not against, scrupulous practitioners, helping them maintain a level playing field so that they are not at a competitive disadvantage to unethical practitioners who are willing to conspire with their clients to cheat the government. Moreover, the IRS believes that the National Taxpayer Advocate does not adequately recognize the intensive efforts OPR has gone to increase the transparency of its operations.

OPR's ultimate responsibility is to protect the public and increased transparency serves this goal. OPR has fought hard to increase its transparency but we also have to consider the

due process rights of practitioners. OPR strives to give practitioners the maximum amount of due process while still protecting taxpayers from unscrupulous practitioners. TAS's goals are identical to OPR's in this regard.

The IRS sees the first two prongs of OPR's mission, setting and communicating standards, as vital to OPR's operation. We believe that the vast majority of practitioners are trying to do "the right thing." However, through a combination of increasing complexity of the tax code and a lack of awareness of their ethical obligations, sometimes practitioners fall short.

One of the important successes in providing transparency to practitioners includes a hard fought change to OPR's ability to disclose cases that OPR has brought to hearing. New regulations under 31 C.F.R. Title 10, commonly known as "Circular 230," were issued on September 26, 2007. Prior to the new regulations, the only information OPR could release about a practitioner's sanction, was, essentially, his or her name, their hometown and state, and the fact of the sanction. OPR could not even release which provision of Circular 230 had been violated. It has been difficult, if not impossible, under these restrictions to affect practitioner behavior. Practitioners simply did not know what areas caused OPR the most concern.

After weighing practitioner concerns about due process, decisions of the Administrative Law Judge and Appellate Authority will be made publicly available after the hearing, when the proceeding is final. Information that reveals third party identities will be redacted.

A decision becomes a final agency decision at two possible points: (1) Thirty days after the Administrative Law Judge renders his or her decision if the practitioner does not appeal or (2) After the Secretary of the Treasury or his delegate renders an opinion on the appeal. To further enhance transparency, OPR will offer a look-up feature on its web site so that practitioners can more easily access these opinions.

OPR conducts dozens of outreach efforts each year through speeches, panel presentations and training, externally and internally, both to keep our core constituency alert to their ethical duties and to provide transparency to our operations. Recently, a Senior Staff member has been assigned full-time to working on issues of increasing OPR's transparency. We are also working diligently to broaden our IRM to include more information to the public about OPR's enforcement procedures.

Additionally, as noted by the National Taxpayer Advocate, the IRS recently formed an Advisory Committee under IRPAC that will meet with OPR to discuss the real world dilemmas faced by practitioners on a day by day basis. We envision that OPR will accept and answer questions that are from hypothetical situations posed by the group as one way to provide better guidance to the practitioner community.

In creating the committee, the IRS worked closely with the National Public Liaison (NPL) office. NPL advised early on that the best approach to creating this new committee would



be to create a sub-group to IRPAC. The National Taxpayer Advocate states that the committee may not be composed of the most qualified individuals; however, NPL solicited for new members to participate on the subcommittee through the organizations that represent OPR's constituency, not existing members of IRPAC. The committee, when finalized, should have members from the ABA, AICPA, and the American Society of Appraisers among others. We are awaiting Treasury confirmation of these members and we hope to hold the first subcommittee meeting in January, 2008. In addition, we chose to set up a subcommittee rather than a new Advisory Committee as the process was much faster. We worked as expeditiously as possible, through NPL, to inform all the relevant groups of our intent to form the committee, and NPL solicited the members through their solicitation process. We followed all appropriate procedures in soliciting membership. The background checks and other requirements for membership simply take time.

Precisely because the membership does represent OPR's core constituencies, the hypotheticals they pose and we answer will provide helpful guidance to practitioners, and will be available to them on the IRS website.

As a result of all of these initiatives, OPR has made significant strides in the past year in terms of dedicating itself to the very important issue of transparency. However, the IRS recognizes that there is more that needs to be done, and appreciates the National Taxpayer Advocate's comments and recommendations.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate commends OPR for recognizing, in the IRS response, that transparency is very important. She is also pleased that OPR has agreed to include more information about its enforcement procedures in its IRM. Its plans to publish final decisions, to assign someone within OPR to work on transparency issues, and to conduct training and outreach are also steps in the right direction.

However, as noted above, practitioners cannot rely on speeches, particularly speeches in which the IRS representative provides unhelpful advice not to worry about a "foot fault," to determine what conduct is prohibited.<sup>51</sup> Moreover, practitioners cannot rely on speeches to figure out whether OPR is applying its procedures fairly and consistently in a particular case. Although the final decisions that OPR plans to make available on its website will provide a retrospective look at OPR's enforcement activities and legal positions, these decisions may not always reflect OPR's current practices or positions. Thus, it is very important for OPR to publish current substantive and procedural guidance that practitioners can rely on.

<sup>51</sup> As noted above, IRS officials sometimes respond to questions about Circular 230 by telling practitioners to use "common sense" assuring them that OPR won't pursue "foot faults." See, e.g., Sam Young, *Key Definitions in IRS Practice Regs Remain Unclear*, 2007 TNT 213-6 (Nov. 2, 2007) (reporting: "An audience member asked whether failure to file his own tax return would qualify as 'disreputable conduct' as defined under the regs or would be deemed a 'foot fault.' Warren ... explained that the foot fault protection is designed so that 'we will not give you an owie for an inadvertent boo-boo.'").



Expanding OPR's IRM and publishing additional guidance in the Internal Revenue Bulletin would both be helpful in this regard.

While the National Taxpayer Advocate appreciates the growing pains that OPR has experienced, nothing has prevented OPR from issuing such guidance in recent years. It should do so without further delay.<sup>52</sup> Unfortunately, the IRS comments fail to commit to a specific date for issuing guidance (in the form of an IRM or otherwise), to the content of any such guidance, or to seek input from the National Taxpayer Advocate or other stakeholders in developing the guidance.

We were also surprised to read in the IRS response that the OPR only envisions using an advisory committee to come up with hypothetical situations that pose questions for OPR to answer. We had assumed that OPR would use the advisory committee to help it with a broader range of issues, especially since OPR could invent hypothetical questions on its own without the delay of forming a committee. At the very least the advisory committee should help OPR formulate hypothetical examples that illustrate *answers* to difficult questions (rather than just questions). Developing answers to close questions with input from an advisory committee composed of practitioners who are subject to these rules will result in more reasonable interpretations of existing guidance. Moreover, such a process is more like the self-regulatory process used by stakeholder organizations such as state bar associations.<sup>53</sup>

If the IRS had used an open process to establish its advisory committee, neither the National Taxpayer Advocate nor the public would be surprised by the planned scope of its duties.<sup>54</sup> An open process would give the public and practitioner groups an opportunity to express their views, helping the IRS make better and more informed decisions that it is less likely to have to rethink. Moreover, it would allow more qualified professionals an oppor-

<sup>52</sup> Recent publicity about OPR's enforcement activity may cause practitioners to question IRS statements that OPR does not pursue mere "foot faults," and further increase the need for immediate guidance. OPR recently reached a settlement with attorneys over allegations that they failed to satisfy the due diligence requirements of Circular 230 in connection with the tax aspects of a municipal bond opinion. IRS Announces Groundbreaking OPR Settlement with Attorneys, IR-2007-197 (Dec. 6, 2007), available at <http://www.irs.gov/newsroom/article/0,,id=176212,00.html>. In the settlement, which the parties agreed does not constitute an admission of wrongdoing or sanction, the attorneys agreed to comply with their firm's practices and procedures and to allow OPR to publicize the settlement. This partial publicity leaves other practitioners wondering what the attorneys did wrong. If the attorneys did nothing wrong, as they continue to maintain, OPR appears to be bullying innocent practitioners. If the attorneys did something wrong, as asserted by OPR, other practitioners are left wondering whether OPR was pursuing a "foot fault" or letting them off easy for the sake of publicity. In the absence of specific information about what due diligence OPR believes they failed to undertake, such publicity could serve to increase the anxiety of others issuing tax exempt bond opinions and suspicion that OPR may sometimes arbitrarily pursue goals other than unbiased and independent administration of Circular 230.

<sup>53</sup> With respect to rules of professional conduct, there is often an acknowledgment that the individuals best able to evaluate the actions of the accused should include other individuals who are subject to the same rules. For example, 70 percent of the members of the group charged with determining whether to discipline members of the Virginia State Bar may be practicing attorneys. See Virginia State Bar, *2006-2007 Professional Guidelines*, 116, B.2.b (Establishment of District Committees), available at [http://www.vsb.org/docs/2007-08\\_pg.pdf](http://www.vsb.org/docs/2007-08_pg.pdf). See Circular 230 § 10.38.

<sup>54</sup> Prior to its revision dated November 2, 2007 (available at [http://www.irs.gov/pub/irs-utl/irpac\\_2007\\_renewal\\_charter.pdf](http://www.irs.gov/pub/irs-utl/irpac_2007_renewal_charter.pdf)), IRPAC's Charter provided that IRPAC's "Duties and Responsibilities" were to:

[i]dentify, research, analyze, and provide recommendations regarding specific information reporting issues, current or proposed IRS information reporting policies, programs, and procedures, and, when necessary, suggest improvements to information reporting operations and/or administration of the Information Reporting Program. Charter for the Information Reporting Program Advisory Committee (Nov. 5, 2005).

tunity to volunteer to help the IRS undertake the important work of defining the bounds of the ethical rules applicable to tax practitioners.

IRS lawyers have advised that OPR's subcommittee is not subject to the normal transparency rules applicable to stand-alone advisory committees, explaining:

Because the IRPAC charter indicates that its subcommittees will report to the parent committee, the subcommittee is not subject to [the Federal Advisory Committee Act's] FACA's requirements, including the requirements to have a balanced membership, to hold open meetings, or to publish Federal Register notices. The FACA requirements will apply when the parent committee deliberates on the findings and recommendations of the subcommittees at a public meeting.<sup>55</sup>

As a consequence, the subcommittee's deliberations on what is ethical – what hypotheticals should be considered, and what answers are appropriate to the hypotheticals – are *not* subject to FACA requirements for open meetings. All of these discussions, except the final recommendations, can be done in dark, with a “public” approval by the full committee without any discussion. This structure is inconsistent with OPR's expressed desire for transparency. For these reasons, OPR should work to establish a stand-alone advisory committee, which is subject to FACA's open meeting requirements, and devoted solely to OPR-related issues.

## Recommendations

In summary, the National Taxpayer Advocate recommends that OPR:

1. Quickly formalize and publish a more detailed description of its enforcement processes, including the analysis OPR employees use to determine which cases are worth pursuing or what sanctions (or range of sanctions) are appropriate for a given offense.
2. Establish a timetable for when the guidance referenced in Recommendation 1 will be circulated inside the IRS and ultimately published.
3. Expedite efforts to publish examples or other guidance to clarify important rules, including:
  - How to determine whether written tax advice is a “covered opinion;”
  - What constitutes “willful” conduct for purposes of Circular 230;
  - Whether a statute of limitations applies to violations of Circular 230; and

<sup>55</sup> E-mail from Office of Chief Counsel to TAS (Dec. 21, 2007).

- What it means to “practice” before the IRS.<sup>56</sup>
4. Work with the Department of the Treasury to amend Circular 230 to incorporate guidance about how the practitioners may obtain exculpatory evidence and how and when they can obtain “open file” discovery.
  5. Establish a stand-alone advisory committee under the Federal Advisory Committee Act for OPR so that a diverse array of tax professionals, including those with experience defending practitioners in proceedings against OPR, has an opportunity to serve.
  6. Expand the role of OPR’s advisory committee so it can provide advice to OPR on a broad range of issues, including assisting OPR with both the questions and answers to be addressed by hypothetical examples.

<sup>56</sup> OPR can begin publishing examples without the assistance of an advisory committee as it has done in the past. Any such guidance should be developed with input from the public, however. To the extent the guidance is likely to be particularly difficult or controversial, OPR should use the regulation-making process to incorporate it into Circular 230.

MSP  
#9

## Preparer Penalties and Bypass of Taxpayers' Representatives

### Responsible Official

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Operating Division

### Definition of Problem

Without a current national system to regulate unenrolled tax return preparers, the IRS needs to effectively use the tools at hand to address incompetent or unscrupulous tax return preparers. However, through the following inactions, the IRS is sending a message to preparers that it tolerates noncompliance:

- The IRS does not consistently assess and collect preparer penalties, and
- The IRS has taken no enforcement action on either criminal or civil penalties for unauthorized use and disclosure of tax return information under Internal Revenue Code (IRC) §§ 7216 and 6713; and

The National Taxpayer Advocate will continue to evaluate IRS oversight of Electronic Return Originators (EROs), which are “Authorized IRS *e-file* Providers” (Providers). The IRS needs to continually check to determine whether all individuals identified on the ERO application as Principals, Responsible Officials, and Delegated Users have unpaid preparer penalties assessed against them. Furthermore, the IRS needs to determine whether ERO applicants claiming not-for-profit status are actually not-for-profits.

While the IRS inadequately enforces preparer penalty provisions, it is also failing to abide by existing power of attorney bypass procedures. More importantly, the IRS is considering amending procedural rules to allow IRS employees to work directly with represented taxpayers who initiate contact with the IRS. The existing bypass procedures were designed to protect against over-reaching by the government, and by failing to follow them, or by amending them, the IRS is depriving taxpayers of their right to representation.

Finally, the National Taxpayer Advocate is concerned about the recent changes to IRC § 6694.<sup>1</sup> The higher standards of conduct put in place by the changes may affect the way tax preparers dispense advice and, in some cases, create conflicts of interest between preparers and their clients.

<sup>1</sup> IRC § 6694 imposes monetary penalties on tax return preparers for understatements due to unreasonable positions and understatements due to willful or reckless conduct.

## Analysis of Problem

### Assessment and Collection of Preparer Penalties

As illustrated in the table below, the IRS has collected only slightly more than 20 percent of net assessed return preparer penalties under IRC §§ 6694 and 6695<sup>2</sup> in the last six fiscal years. The IRS collected approximately 25 percent of the assessed amount in fiscal year (FY) 2007.

**TABLE 1.9.1, IRS Assessment and Collection of IRC §§ 6694 and 6695  
Return Preparer Penalties for FY 2002-2007<sup>3</sup>**

Fiscal Year	Penalty Assessment Amt	Penalty Abatement Amt	Dollars Applied to Penalties <sup>4</sup>	Percentage of Net Assessed Return Penalties Collected
2002	\$1,095,033	\$80,493	\$268,767	24.54%
2003	\$2,427,198	\$247,000	\$267,324	11.01%
2004	\$1,052,550	\$52,725	\$303,845	28.87%
2005	\$910,752	\$89,850	\$337,832	37.09%
2006	\$1,856,461	\$48,450	\$212,733	11.46%
2007	\$2,736,725	\$63,250	\$681,974	24.92%
<b>Total</b>	<b>\$10,078,719</b>	<b>\$581,768</b>	<b>\$2,072,475</b>	<b>20.56%</b>

However small the assessed penalties may have been relative to the IRS's other enforcement efforts, these penalties may effectively deter noncompliance by preparers and, more importantly, have a cascading effect to increase compliance by their clients. In addition, by assessing but not collecting these penalties, the IRS is sending a mixed message about whether it will tolerate poor performance by preparers<sup>4</sup>

It is important to note that the authorized amount of preparer penalties imposed under IRC § 6694 was significantly increased effective May 25, 2007.<sup>5</sup> The National Taxpayer Advocate will continue to monitor the IRS's assessment and collection efforts in light of the new legislative changes. Her concerns about the changes to IRC § 6694 are detailed below.

<sup>2</sup> Net penalties assessed are equal to the total amount of preparer penalties assessed, minus the total amount of penalties abated. IRS, Enforcement Revenue Information System (ERIS) data as of September 2006, IRC §§ 6694 and 6695 Preparer Penalty Data.

<sup>3</sup> IRS ERIS Data; IRC §§ 6694 and 6695 Penalty Data (through Sept. 2007). These numbers exclude penalty reference 622, understatement of taxpayer liability by income tax preparer.

<sup>4</sup> For a detailed discussion on the impact of penalty enforcement on compliance, see Joint Committee on Taxation, *Committee Print: Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters)* 31-37, JCS-3-99 (July 22, 1999).

<sup>5</sup> The IRS provided transitional relief for the standard of conduct provisions in the amendment to IRC § 6694. Notice 2007-54 (June 11, 2007).

### Enforcement of IRC §§ 7216 and 6713<sup>6</sup>

The IRS does not currently enforce the penalties imposed under IRC §§ 6713 and 7216. IRC § 7216 imposes criminal penalties on preparers who knowingly or recklessly make unauthorized disclosures or uses of information furnished to them in connection with the preparation of an income tax return. IRC § 6713 imposes civil penalties on preparers for disclosure or use of this information unless an exception under the rules of IRC § 7216(b) applies. Because safeguarding taxpayer data is crucial to the integrity of the tax system, the IRS should give utmost priority to the enforcement of these penalties. However, the IRS has not assessed or collected any penalties under either section during the period reviewed by our office (2002 through 2007).

### Authorized IRS e-file Providers

In the 2005 and 2006 Annual Reports to Congress, the National Taxpayer Advocate raised concerns about inadequacies in the IRS's performance of initial suitability checks and subsequent monitoring of electronic return originators (EROs).<sup>7</sup> The Treasury Inspector General for Tax Administration (TIGTA) recently audited the *e-file* program and raised similar concerns.<sup>8</sup> While the National Taxpayer Advocate still maintains that the IRS needs to improve suitability checks and *e-file* monitoring, we will pay close attention to the process utilized by the IRS to periodically monitor all individuals identified on the ERO application as Principals, Responsible Officials, and Delegated Users to determine whether they have outstanding preparer penalties assessed against them. By awarding an ERO designation to a business organization, the IRS is providing that organization with the privilege of participation in IRS *e-file* as an "Authorized IRS *e-file* Provider." The IRS should not grant entry into the *e-file* program or allow an existing ERO to continue participating if any of the individuals listed on the ERO application owe uncollected preparer penalties. The IRS needs a comprehensive and permanent program to systematically check for outstanding preparer penalties on those individuals given the privilege of participating in the *e-file* program. It is insufficient to perform tax compliance checks solely during the application process and *e-file* monitoring visits. The IRS should perform periodic tax compliance checks on

<sup>6</sup> For more information on revisions to the regulations under IRC § 7216, see Most Serious Problem, *The Use and Disclosure of Tax Return Information by Preparers to Facilitate the Marketing of Refund Anticipation Loans and Other Products with High Abuse Potential*, *infra*.

<sup>7</sup> National Taxpayer Advocate 2005 Annual Report to Congress 223-237; National Taxpayer Advocate 2006 Annual Report to Congress 197-221. An ERO originates the electronic submission of income tax returns to the IRS. The returns submitted by the ERO are either prepared by the ERO or collected from a taxpayer. For a detailed discussion of ERO's roles and responsibilities, see IRS Pub. 1345, *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns*.

<sup>8</sup> Treasury Inspector General for Tax Administration, Ref. No. 2007-40-176, *Better Screening and Monitoring of E-File Providers Is Needed to Minimize the Risk of Unscrupulous Providers Participating in the E-File Program* (Sept. 19, 2007). TIGTA found that the IRS effectively performed the tax compliance portion of suitability checks on Principals and Responsible officials listed on ERO applications. However, tax compliance checks were not adequately performed on applicants that claimed they were not-for-profit services. In addition, TIGTA found the IRS did not verify citizenship, credit checks, or criminal background checks. Finally, TIGTA found the IRS does not have a process to review e-file Provider cases worked by its Criminal Investigation (CI) function.

the individuals identified on the ERO application as Principals, Responsible Officials and Delegated Users.<sup>9</sup>

Moreover, in its recent audit of the IRS *e-file* program, TIGTA found the IRS does not verify whether ERO applicants claiming not-for-profit status are actually not-for-profits. Once an applicant checks the box on the application indicating such status, the applicant is excluded from all *e-file* program requirements and suitability checks. Thus, the IRS provides a broad exclusion to these entities without even checking to ensure that they qualify for the exclusion. TIGTA recommended that the IRS perform such verification procedures in the application process, and the IRS agreed.<sup>10</sup> The National Taxpayer Advocate will monitor the IRS's progress on this initiative.

### Power of Attorney Bypass

Practitioners have raised concerns about the IRS improperly bypassing taxpayers' representatives. All taxpayers have the right to appoint an individual, who is authorized to practice before the IRS, to act on the taxpayer's behalf by filing a Form 2848, Power of Attorney and Declaration of Representative. Once the taxpayer files a valid Form 2848, the IRS must recognize the appointment and will generally direct all communications to the representative.<sup>11</sup>

IRC § 7521(c) authorizes IRS employees to contact a taxpayer directly only if the employee believes the taxpayer's "representative is responsible for unreasonable delay of an [IRS] examination or investigation of the taxpayer." However, the employee must first obtain the consent of an immediate supervisor and document the file.<sup>12</sup> Treas. Reg. § 601.506(b) provides that once the supervisor grants permission, the employee must send a written notice of the supervisor's permission ("bypass letter") to both the taxpayer and the taxpayer's representative briefly stating why the permission was granted, together with a request to the taxpayer to supply any necessary nonprivileged information.<sup>13</sup> However, before issuing the "bypass letter" mentioned above, IRS employees are instructed to first send a "warning letter" to the representative conveying advance notice of a possible bypass.<sup>14</sup>

<sup>9</sup> A Principal includes a sole proprietor, partners, or individuals authorized to act for the entity in legal and/or tax matters. A Responsible Official is the first point of contact with the IRS and has the authority to sign IRS e-file applications. A Delegated User is an individual within the organization who is authorized to use one or more of the e-services products. Suitability checks are currently not performed on Delegated Users, because they are deemed to be the responsibility of the Principals and Responsible Officials. IRS Publication 3112, *IRS e-file Application and Participation* (Nov. 2004).

<sup>10</sup> Treasury Inspector General for Tax Administration, Ref. No. 2007-40-176, *Better Screening and Monitoring of E-File Providers Is Needed to Minimize the Risk of Unscrupulous Providers Participating in the E-File Program* (Sept. 19, 2007).

<sup>11</sup> Generally, all written correspondences should be sent to both the taxpayer and the representative. Treas. Reg. § 601.506(a).

<sup>12</sup> Generally, all written communications will be sent to both the taxpayer and the representative. Treas. Reg. § 601.506; IRC § 7521.

<sup>13</sup> IRM 1.4.40-11 to -13.

<sup>14</sup> Letter 4020-A, Warning Letter for Bypass Procedures for Preparers Covered under Circular 230; Letter 4020-B, Warning Letter for Bypass Procedures for Un-enrolled Preparers; IRM 1.4.40-9,10 (March 1, 2007); IRM 1.4.40.3.8.3(3). The Collection IRM states the taxpayer should not be copied on the warning letter. IRM 5.1.1.7.7.1 (Aug. 21, 2006). However, the Examination IRM states that the taxpayer should be copied on all correspondences, including the bypass warning letter. Later, the Examination IRM includes a contradictory statement saying that the taxpayer should not be copied on the warning letter. IRM 4.11.55.3.2(3)(b) (Mar. 1, 2007).



The National Taxpayer Advocate is concerned about the IRS's application of the bypass authority given to IRS employees in IRC § 7521(c). IRS guidance to examination and collection employees states that the following types of behavior may warrant a bypass:

- Failure to submit the taxpayer's records or information requested by the employee;
- Failure to keep scheduled appointments; and
- Failure to return telephone calls and written correspondence.

IRS employees are instructed to note any trends in such behavior before instituting bypass procedures. However, guidance provided to examination employees specifically references procrastination as a potential behavior causing an unreasonable delay or hindrance.<sup>15</sup> Mere procrastination by a representative should not provide the IRS with an opportunity to ignore a taxpayer's fundamental right to representation. An IRS employee can easily label a representative's conduct as "procrastination" despite the fact that the representative may, in actuality, be diligently working the client's case. The cause of the delay could stem from the client's own behavior and not unreasonable conduct on the part of the representative. In addition, a representative may intentionally withhold information and wait for the IRS to issue a summons when the representative determines such action is in the best interest of the client.

Practitioners from the Low Income Taxpayer Clinic (LITC) program have raised the concern that IRS employees in various functions have completely bypassed representatives without reason and with complete disregard for the bypass procedures detailed above.<sup>16</sup> Some practitioners have suggested that the inappropriate bypasses may be a result of improper training on procedures in this area. Although various Internal Revenue Manual (IRM) provisions cover issues related to taxpayer representation, it is imperative for the IRS to ensure that all employees with direct taxpayer contact are properly trained on this matter. Thus, the topic of taxpayer representation, with a detailed discussion on the proper procedures to bypass a representative, warrants inclusion in mandatory briefings provided annually to all IRS employees.

The IRS is currently considering amending existing bypass procedures to allow the IRS to communicate directly with represented taxpayers who initiate contact with the IRS.<sup>17</sup>

<sup>15</sup> IRM 4.11.55.3.2 (Mar. 1, 2007); IRM 5.1.1.7.7(3) (Aug. 21, 2006).

<sup>16</sup> American Bar Association Low Income Taxpayer Clinic Discussion Online Forum Postings (Sept. 25, 2007 and Oct. 2, 2007). After we raised these concerns with the management of the Wage & Investment Operating Division Compliance function, the function immediately responded and promised to retrain employees on the proper procedures regarding communication with represented taxpayers. Email from Director, W&I Compliance (Oct. 1, 2007) (on file with author).

<sup>17</sup> Memorandum from Deborah A. Butler, Associate Chief Counsel (Procedure & Administration) to James M. Grimes, Director, Wage & Investment Compliance (Oct. 16, 2007) (on file with author). The IRS can change the procedures contained in the IRM and Treas. Reg. § 601.506 administratively. Part 601 of the Treasury regulations is issued by the Commissioner of the IRS and can be modified without approval by Treasury. *Boulez v. Comm'r.*, 810 F.2d 209 (D.C. Cir. 1987).

The National Taxpayer Advocate strongly opposes such amendments.<sup>18</sup> Taxpayers who have filed a Form 2848 with the IRS have indicated on the form that they would like the designated individual to represent them before the IRS. If taxpayers have changed their minds regarding such representation, they can either file a new form to restrict the representative's authorities or request their representative to grant written permission for such direct contact.<sup>19</sup> Otherwise, the IRS needs to respect the wishes expressed by the taxpayer in writing on the Form 2848 on file with the IRS. These procedures are in place to protect taxpayers. Without the representative present, a taxpayer could unwittingly enter into a binding arrangement with the IRS that is not necessarily in the taxpayer's best interest.<sup>20</sup>

### Recent Changes to Standard of Conduct in § 6694 Preparer Penalties

#### Background

Section 8246 of the Small Business and Work Opportunity Act of 2007<sup>21</sup> recently amended IRC § 6694 as follows.

- **Increased Penalties.** The legislation raised the penalties imposed on return preparers for understatements due to unreasonable positions from \$250 to the greater of \$1,000 or 50 percent of the income derived (or to be derived) by the preparer with respect to the return or claim. In addition, the legislation increased penalties for understatements due to willful or reckless conduct from \$1,000 to the greater of \$5,000 or 50 percent of the income derived by the preparer with respect to the return or claim in question.
- **Expanded Application of Penalties to Taxes Other Than Income.** Before the amendment, IRC § 6694 applied to only income taxes. The new legislation applies the penalties to all types of tax returns, including estate and gift tax, employment tax, and excise tax returns.
- **Higher Standard of Conduct on Undisclosed Positions.** The amendment established a higher standard of conduct for preparers to avoid imposition of penalties when the IRS alleges that the preparer knew or reasonably should have known of an unreasonable position. The old standard required the position taken on the return to have a "realistic possibility of being sustained on its merits." The new standard requires "a reason-

<sup>18</sup> The National Taxpayer Advocate understands that taxpayers may have concerns about paying professional fees for what are essentially ministerial acts. However, these concerns can be addressed by permitting IRS employees to directly communicate with represented taxpayers when such taxpayers initiate contact with the IRS for purposes which amount to de minimis actions on the part of the IRS, such as providing a taxpayer with a pay-off amount or changing the taxpayer's address.

<sup>19</sup> See Instructions for Form 2848, *Power of Attorney and Declaration of Representative*; IRS Pub. 947, *Practice Before the IRS and Power of Attorney* (May 2004).

<sup>20</sup> Note that Rule 4.2, *Communication With Person Represented By Counsel*, of the American Bar Association Model Rules of Professional Conduct states "In representing a client, a lawyer shall not communicate about the subject of the representation with a person the lawyer knows to be represented by another lawyer in the matter, unless the lawyer has the consent of the other lawyer or is authorized to do so by law or a court order." Further, the Comment to Rule 4.2 states "[t]his Rule contributes to the proper functioning of the legal system by protecting a person who has chosen to be represented by a lawyer in a matter against possible overreaching by other lawyers who are participating in the matter, interference by those lawyers with the client-lawyer relationship and the uncounselled disclosure of information relating to the representation.... The Rule applies even though the represented person initiates or consents to the communication."

<sup>21</sup> Pub. L. No. 110-28, 121 Stat. 112 (May 25, 2007).

able belief that the position would more likely than not be sustained on its merits.” Regulation § 1.6694-2(b) translates the previous realistic possibility standard to equate to a one in three (approximately 33 percent) or greater likelihood of being sustained on its merits. The new standard translates to approximately 51 percent or greater likelihood, which is significantly higher than the substantial authority standard that applies to taxpayers.<sup>22</sup>

- **Higher Standard of Conduct on Disclosed Positions.** The legislation also establishes a higher standard of conduct for disclosed unreasonable positions as well. Previously, the preparer could avoid penalties on disclosed unreasonable positions if the position was not frivolous. Now the preparer must have a reasonable basis for the disclosed position. This change actually makes the standard for disclosed positions the same for taxpayers and preparers.<sup>23</sup>
- **Effective Date of Legislation.** The legislation was effective upon enactment. Thus, the new rules apply to positions on returns prepared after May 25, 2007. However, as described below, the IRS issued guidance providing transitional relief.

In the interest of effective tax administration and in response to practitioner concerns about the effective date of the new legislation,<sup>24</sup> the IRS issued Notice 2007-54<sup>25</sup> to provide transitional relief. The transitional relief provides the following:

- **Returns, Amended Returns and Claims for Refund for Income Taxes.** With respect to understatements due to an unreasonable position, the standards included in the previous law and current regulations apply to income tax returns, amended returns, or claims due on or before December 31, 2007.
- **Returns, Amended Returns, and Claims for Refund for Taxes Other Than Income Taxes.** For all other returns, amended returns, and claims due on or before December 31, 2007 that include an understatement due to an unreasonable position, the reasonable basis standard defined in Treas. Reg. § 1.6662-3(b)(3) will apply.<sup>26</sup> The relief also applies to

<sup>22</sup> IRC § 6662(d)(2). The new standard of conduct in IRC § 6694 also created an inconsistency with the standard of conduct currently in Circular 230. Currently, § 10.34 of Circular 230 includes the previous standards of conduct in former IRC § 6694. Therefore, practitioners have a lower standard of conduct to avoid sanctions under Circular 230. This inconsistency creates the potential for confusion. To address this issue, the Department of Treasury issued a notice of proposed rulemaking to conform § 10.34 to the new language in IRC § 6694. 72 Fed. Reg. 54,621 (to be codified at 31 C.F.R. pt. 10) (proposed Sept. 26, 2007).

<sup>23</sup> IRC § 6662(d)(2)(B).

<sup>24</sup> Practitioners raised concerns about the effective date of the new requirements. Revised IRC § 6694 is effective for returns prepared after May 25, 2007. Thus, identical positions taken on practitioner-prepared returns for different taxpayers with the same tax year could be held to different standards. See, e.g., *AICPA Seeks Transitional Relief for Return Preparer Penalty Provisions*, Tax Notes Today (June 28, 2007); *PricewaterhouseCoopers LLP, PWC Seeks Transitional Relief for Return Preparer Penalty Provisions*, Tax Notes Today (July 6, 2007).

<sup>25</sup> 2007-27 I.R.B. 12 (June 11, 2007).

<sup>26</sup> Treas. Reg. § 1.6662-3(b)(3) states “Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities set forth in § 1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard as defined in § 1.6662-4(d)(2).”

2007 estimated tax returns due on or before January 15, 2008 and 2007 employment and excise tax returns due on or before January 31, 2008.

- *Understatement Due to Willful or Reckless Conduct.* There is no transitional relief provided for return preparers who exhibit willful or reckless conduct.
- The Department of Treasury and the IRS Office of Chief Counsel have committed to release detailed guidance on the new IRC § 6694 language.<sup>27</sup>

### *Ethical Concerns*

Subsequent to the enactment of the legislation, the practitioner community voiced concerns over the change in the standard of conduct required to avoid the imposition of IRC § 6694 penalties.<sup>28</sup> The National Taxpayer Advocate is particularly concerned that the legislation created a significant disparity between the standard applicable to preparers and the standard applicable to taxpayers. This disparity can potentially lead to ethical problems for preparers which in turn will affect how they advise their clients.

The practitioner standard requiring that the position would more likely than not be sustained on its merits is now considerably stricter than the taxpayer standard. Undisclosed positions on returns prepared by taxpayers are subject to the substantial authority standard.<sup>29</sup> Treas. Reg. § 1.6662-4(d)(2) specifically states that the “substantial authority” standard is less stringent than the “more likely than not” standard.<sup>30</sup>

Recent changes to the standard of conduct may cause preparers to recommend that their clients include numerous disclosures in their tax returns. This development has the potential to place the preparer in an ethical dilemma, because the preparer needs to recommend a course of action to protect the preparer’s interest even though it may not be in the client’s best interest. Form 8725, Disclosure Statement, was designed for taxpayers to disclose information to avoid IRC § 6662 penalties.<sup>31</sup> In cases where there is substantial authority for a certain position taken on a return and the client is confident that the IRS will not impose IRC § 6662 penalties, the client has no incentive to sign a disclosure statement to protect

<sup>27</sup> Dustin Stamper, *Officials Pledge to Clean Up Preparer Penalties*, Tax Notes Today (Oct. 2, 2007).

<sup>28</sup> Practitioner comments are based on phone conversations between the Office of the Taxpayer Advocate and several practitioners, discussions at focus group sessions held at the 2007 IRS Nationwide Tax Forums, and articles published in Tax Notes. Lee Sheppard, *News Analysis: How Much Trouble Can You Get Into?* Tax Notes Today (June 14, 2007); Jeffrey R. Hoops, *AICPA Seeks Transitional Relief for Return Preparer Penalty Provisions*, Tax Notes Today (June 28, 2007); PricewaterhouseCoopers LLP, *PWC Seeks Transitional Relief for Return Preparer Penalty Provisions*, Tax Notes Today (July 6, 2007); Kathy Stanek, *Tax Professionals Object to Increased Tax Return Reporting Standards*, Tax Notes Today (Aug. 28, 2007).

<sup>29</sup> IRC § 6662(d)(2).

<sup>30</sup> Treas. Reg. § 1.6662-4(d)(2) states “[t]he substantial authority standard is less stringent than the more likely than not standard ... but more stringent than the reasonable basis standard as defined in § 1.6662-3(b)(3).” Treas. Reg. § 1.6662-4(d)(3) states that “[t]here is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment.”

<sup>31</sup> It is the understanding of the Office of the Taxpayer Advocate that guidance on the appropriate use of Form 8275, *Disclosure Statement*, is currently in the drafting stage at the time this report goes to print.

the preparer. Thus, the preparer is placed in a very difficult position if he or she hopes to avoid preparer penalties.<sup>32</sup>

The “more likely than not” standard may also discourage preparers from interpreting ambiguous tax rules in a taxpayer-friendly manner. Specifically, preparers can avoid significant penalties only if they disclose a reasonably based position or ensure there is at least a 51 percent possibility that any undisclosed position would be sustained on its merits. In situations where the applicable tax law is ambiguous or not well developed, preparers may shy away from undisclosed positions that are aggressive yet reasonable interpretations of the law if they face the threat of sizeable penalties.<sup>33</sup> Further, preparers may have ethical reasons to avoid disclosing certain tax return positions to the IRS if the taxpayers’ substantial authority standard of conduct has been met, but the preparers’ more likely than not standard has not.

## Conclusion

To increase preparer compliance, the IRS needs to effectively assess and collect preparer penalties. Collecting only slightly more than 20 percent of assessed preparer penalties under IRC §§ 6694 and 6695 during the past six years is inadequate. The IRS is also putting taxpayers at risk by failing to enforce the criminal and civil penalties under IRC §§ 6713 and 7213. In addition, the IRS should develop a comprehensive and permanent program to systematically check whether all individuals identified on the ERO application as Principals, Responsible Officials, and Delegated Users have unpaid preparer penalties assessed against them.

The National Taxpayer Advocate will monitor the IRS’s implementation of its authority to bypass taxpayer representatives. While the tool exists to protect clients against incompetent or unethical practitioners, the IRS should only employ this tool when absolutely necessary. By not providing proper guidance to IRS employees and by not following its own procedures, the agency risks depriving taxpayers of their fundamental right to representation.

Finally, the Office of the Taxpayer Advocate will continue to monitor the recent changes to IRC § 6694, specifically the effect the new increased standards of conduct have on preparer behavior and how the IRS plans to enforce the provisions.

<sup>32</sup> Jonathan S. Brenner, *New Standard for Tax Return Positions is Inappropriate*, Tax Notes Today (Aug. 14, 2007); Lee Sheppard, *News Analysis: How Much Trouble Can You Get Into?* Tax Notes Today (June 14, 2007);

<sup>33</sup> Jonathan S. Brenner, *New Standard for Tax Return Positions is Inappropriate*, Tax Notes Today (Aug. 14, 2007). Practitioners have also raised similar concerns about the possibility of raising the IRC § 6662 standard of conduct to the “more likely than not” standard. Robert J. McDonough, *TEI Opposes Extending Return Preparer Penalty Standard to Taxpayers*, Tax Notes Today (Sept. 20, 2007).

## IRS Comments

A majority of taxpayers rely on return preparers to help them navigate, understand, and comply with their tax obligations. The IRS agrees that return preparers are a critical component of the IRS's goal of increasing voluntary compliance, and is developing a comprehensive and Servicewide Return Preparer Strategy that effectively balances services with consistent enforcement of the tax laws. The goal of the Strategy is to enhance tax administration through collaboration with return preparers by providing clear guidance and effective service support, while ensuring overall compliance with the tax laws.

A majority of tax returns received by the IRS are prepared by paid tax return preparers. There are increasing complexities for the tax filing population due, in part, to frequent law changes and the existence of a more global environment. These complexities affect the demands on the IRS to provide more resources to assist taxpayers and their return preparers so they can meet their tax responsibilities. The IRS must be able to fulfill its obligations in an ever-changing environment, and our mission is to ensure that all points of return preparer contacts with the IRS are a part of its strategy – education, e-services and e-applications, compliance guidelines, enforcement, and modernization efforts.

The framework for the Strategy will focus on several guiding principles:

- Develop a better understanding of the important role of return preparers and how they affect voluntary compliance;
- Identify opportunities to provide service resources that mitigate errors, reduce taxpayer and preparer burden, and increase IRS efficiencies; and
- Ensure a consistent IRS enforcement presence in the return preparer community.

### Assessment and Collection of Preparer Penalties

The IRS agrees that return preparer penalties may decrease noncompliance by preparers and quite possibly increase compliance by their clients. In addition to protecting taxpayers from being harmed by unscrupulous return preparers, the larger compliance impact is certainly a goal of the program. The IRS agrees that improvements can be made in collection of these penalties; however, there are other aspects to measuring the success of the program beyond dollars collected. All preparers who are assessed penalties receive collection notices, with some also being contacted by collection personnel. Based on the preparer's individual financial condition, collection alternatives are considered to resolve the case. These alternatives do not always result in full payment or installment agreements.

The IRS utilizes business rules in the collection case assignment process. Business rules are also used to identify areas of special emphasis, and return preparer cases are identified as "Special Emphasis" because of the compliance nature of the assessment. Current risk-based case assignment practices do not always provide sufficient emphasis on these cases. Therefore, the IRS is implementing programming changes targeted for November

2008 that should allow more preparer penalty cases to be assigned to revenue officers in the collection field function.

### **Enforcement of IRC §§ 7216 and 6713**

Over the past several years, the IRS has, on occasion, asserted the penalty under IRC § 6713, Disclosure or Use of Information by Preparers of Returns. But, given the nature of the penalty, examiners will rarely uncover situations where this penalty would be warranted, which is one factor why the penalty is not more frequently utilized. We agree, however, that additional emphasis on this penalty is needed and have several actions planned to increase awareness including:

- Discussing the penalty during future conference calls with Area Return Preparer Program (RPP) Coordinators and ERO Coordinators;
- Updating the ERO training material to include that if examiners identify a potential violation, a referral should be made to the RPP Coordinator; and
- Updating the IRM pertaining to the RPP to include procedures for applying this penalty.

IRC § 7216 provides for a misdemeanor charge imposing a sentence of not more than one year in jail and fine not more than \$1,000 for the improper disclosure or use of taxpayer information by preparers. This statute can be used to address criminal violations of return preparers typically involved in refund crimes or crimes related to identity theft. The IRS Criminal Investigation Division (CI) generally does not recommend charges under § 7216 because the violation is only a misdemeanor. CI instead recommends felony charges for return preparers who improperly disclose or use taxpayer information while involved in abusive criminal behavior related to the preparation of false tax returns or use of taxpayer information to file fictitious returns in the attempt to obtain fraudulent refunds.

In lieu of IRC § 7216, CI (with the approval of Department of Justice Tax Division) will recommend to the U.S. Attorney's Office that abusive return preparers should be charged under (1) IRC § 7206(2) Aiding or Assisting the Preparation of a False or Fraudulent False Tax Return or Fraudulent Document; (2) 18 U.S.C. § 287 Making False, Fictitious, or Fraudulent Claims for Refund; (3) 18 U.S.C. § 286 Conspiracy to Defraud the Government with Respect to Claims of Tax Refunds; and/or (4) 18 U.S.C. § 1028A Aggravated Identity Theft. These charges are felony charges that impose sentencing of from two years to ten years along with fines of up to \$250,000.

### **Authorized IRS e-file Providers**

The IRS reviews preparer penalties during its Tax Compliance Checks as part of the Suitability Check completed on firms, principals, and responsible officials. Preparer penalties assessed in the last three years over a specified amount, and occurring in more than one tax period, are considered in determining suitability. The IRS uses the Automated



Suitability Analysis Program (ASAP) to identify preparer penalty assessments and unpaid balances that are more than a specific amount. Assessments and unpaid balances are identified by ASAP during processing of *e-file* applications and on a continual basis after acceptance as an authorized IRS *e-file* provider. When criteria are met during the Suitability Check, a transcript is generated to e-Help. Transcripts are generated on a weekly basis. e-Help reviews the information, investigates as needed, and takes the appropriate action, which may include denial, suspension, or expulsion. The suitability process is described in IRM 3.42.10.18.

The Automated *e-file* Application Processing system has been in use for a number of years and automates the process of checking and monitoring tax compliance and ensures that applicants and approved *e-file* providers are current with their tax return filings and tax payments. In addition, this process ensures that individuals and businesses have not been assessed fraud and/or preparer penalties. In a recent TIGTA audit report, a review of 98 applications found that tax compliance checks were correctly performed for the 137 principal and responsible officials and the 94 businesses listed on these applications.

#### Power of Attorney Bypass

The IRS does not agree that employees bypass representatives without reason or disregard the bypass procedures, and has safeguards in place to ensure this does not occur. In field examination, the Territory Manager must approve the bypass of a Power of Attorney (POA). It cannot be issued solely with the approval of the Group Manager. This added step provides additional protection for taxpayers, ensuring that examiners are using bypass provisions only when warranted. The IRM states that a bypass does not prevent the POA from representing the taxpayer, only that the IRS can communicate directly with the taxpayer. The IRM also provides guidelines for when a summons should be used, in lieu of a bypass, when the problem involves the failure to provide records. The detailed procedures provided in IRM 4.11.55 only allow bypass of a POA in defined situations.

Similarly, IRM 5.1.1.7.7 provides detailed guidance to Revenue Officers when they are considering bypassing the taxpayer's representative. These procedures were revised in August 2006, and also require Territory Manager approval for bypassing a representative.

An employee may consider whether to use bypass procedures when the representative has unreasonably delayed or hindered the investigation, or failed to provide requested information necessary to the investigation. Appointments with the representative and document requests are subsequently confirmed in writing, and additional delays or activity documented in the case file. There is managerial involvement if a bypass warning letter is issued, and copies are sent to the Territory Manager and the Area Return Preparer Coordinator to notify them of the potential bypass. If the representative does not respond appropriately to the bypass warning letter within the period of time specified in the letter, a bypass letter is prepared notifying the representative that the representative will be bypassed and outlines the facts and circumstances underlying the decision to bypass. The bypass letter is

approved by the Territory Manager and copies are sent to the taxpayer and the Area Return Preparer Coordinator.

After a bypass letter is sent, the employee may contact the taxpayer directly to obtain the information necessary to make a proper collection determination. Permission to contact the taxpayer directly does not disqualify a representative from acting as the recognized representative of the taxpayer. Even though authorization to bypass the representative was approved, the representative would still be advised in writing of the time and place of future appointments with the taxpayer, and the representative is welcome to attend such appointments. Copies of all correspondence with the taxpayer would also be sent to the representative, even after a bypass is approved.

The National Taxpayer Advocate also expressed concerns that the IRS is considering amending existing bypass procedures to allow campus employees to communicate directly with represented taxpayers who initiate contact with IRS. In the campus environment, our current policy for contacts made by taxpayers with a POA on file is to remind them that they have a POA on file and that they need to have their POA call us or we offer to conference them in on the call. We do not advise them that they can revoke their POA unless the taxpayer initiates that conversation.

The IRS is frequently contacted by taxpayers inquiring about the status of their returns, refunds, and various account issues. Each year Accounts Management provides telephonic and written assistance to respond to millions of taxpayer inquiries. Requests for this assistance are initiated by taxpayers and are generally a solicitation for account-related information or to request actions needed to resolve account-related issues.

A POA is often submitted to obtain representation on a specific matter, such as preparation of a tax return, and is often unrelated to other issues needed to resolve an account issue, such as an address change or an inquiry on the date a refund is being issued. Due to the nature of the services provided by Accounts Management and to relieve taxpayer burden, there is some consideration being given to amending existing bypass procedures to allow the IRS to communicate directly with represented taxpayers who initiate contact with the IRS. The IRS will work with the National Taxpayer Advocate and IRS stakeholders in developing any changes to the bypass procedures.

### **Recent Changes to Standard of Conduct in § 6694 Preparer Penalties**

As noted by the National Taxpayer Advocate, the recent changes made to IRC § 6694 increase the standards for paid preparers. The IRS will work with the National Taxpayer Advocate in implementing the statutory changes and any related Treasury guidance. The IRS will also provide additional procedural guidance and technical training materials to ensure our employees properly apply the new law.

### Summary of Planned Actions

In summary, and in response, the IRS plans to take the following actions:

- Changes to the risk-based case assignment programming are targeted for November 2008 to allow more preparer penalty cases to be assigned to revenue officers in the collection field function;
- Discuss the IRC § 6713 penalty during future conference calls with RPP Coordinators and ERO Coordinators;
- ERO training material will be updated to indicate that if examiners identify a potential violation of IRC § 6713, a referral should be made to the RPP Coordinator;
- The IRM pertaining to RPP will be updated to include examiner procedures for IRC § 6713; and
- Training materials will be developed to educate Service employees on the appropriate application of the new IRC § 6694 standards.

### Taxpayer Advocate Service Comments

The National Taxpayer Advocate appreciates the IRS's commitment to the above-listed specific planned actions. Further, the National Taxpayer Advocate supports development of the Servicewide Return Preparer Strategy. In connection with this initiative, we encourage the IRS to create a Return Preparer Executive Steering Committee, of which the National Taxpayer Advocate should be a member, to oversee the development and implementation, as well as assure coordination, of all service and enforcement programs affecting return preparers throughout the organization.

#### *Assessment and Collection of Preparer Penalties*

Given the multiplier effect of return preparer behavior on taxpayer compliance, the IRS needs to place top priority on assessing and collecting preparer penalties. We applaud the IRS's commitment to put more emphasis on preparer penalty cases through programming changes to risk-based case assignment. Assigning more cases to the collection field function will likely have a positive effect on preparer behavior. However, we encourage such programming changes to incorporate minimal threshold amounts.

#### *Enforcement of IRC §§ 7216 and 6713*

We commend the IRS for placing additional emphasis on and increasing awareness of the IRC § 6713 penalty. We believe incorporation of guidance on this penalty into the appropriate training materials and IRMs, providing detailed information on identification of violations as well as the proper referral procedures, is an important step in enforcing this penalty.

It is discouraging that the IRS does not recommend charges under IRC § 7216 “because the violation is only a misdemeanor.” While CI has limited resources and understandably focuses on felony charges, it is shortsighted to ignore this provision based on the severity of the charge. The IRS should commit to enforce this penalty against preparers who possess the necessary intent because the confidentiality of tax return information is crucial to tax administration.

The misdemeanor charge imposed by IRC § 7216 coupled with the statutory framework of IRC § 6713 creates a difficult tax administration issue. Criminal Investigation cannot devote resources to enforce the penalty because it is “only a misdemeanor.” At the same time, Treasury is not authorized by statute to draft regulations specific to the civil counterpart, IRC § 6713. IRC § 6713 merely refers to regulations drafted under IRC § 7216, leaving Treasury in the position to only address uses and disclosures that rise to the level of a misdemeanor charge.<sup>34</sup>

#### *Authorized IRS e-file Providers*

We are pleased that the IRS periodically reviews preparer penalties during tax compliance checks as part of Suitability Checks on firms, principals, and responsible officials. We encourage the IRS to also perform such checks, with particular emphasis on preparer penalties, on all Designated Users listed in ERO applications. These individuals also enjoy the privilege of participating in the *e-file* program and should be treated similarly with regard to preparer penalties. With respect to all individuals listed on the application, the IRS should review the preparer penalty threshold amount that triggers the generation of a transcript. The threshold relating to preparer penalties should be minimal considering that a preparer’s behavior has a rippling effect on taxpayer compliance. Accordingly, it may be optimal for the Automated Suitability Analysis Program to distinguish between taxpayer and preparer penalties and place greater emphasis, with lower threshold amounts, on preparer penalties.<sup>35</sup>

#### *Power of Attorney Bypass*

The IRS must commit to provide all employees who have direct taxpayer access with proper training on issues related to taxpayer representation. Such training should include a detailed discussion of the rules regarding communications with represented taxpayers as well as bypass procedures. The training should also cover the type of behavior warranting a bypass, with specific instructions that mere procrastination on the part of the practitioner is an insufficient reason to institute bypass procedures. Bypass procedures exist to protect the taxpayer’s right to representation. It is imperative that the IRS provide adequate guidance to its employees on this matter.

<sup>34</sup> See the Additional Legislative Recommendation in this report to authorize Treasury to issue guidance specific to IRC § 6713 regarding the use and disclosure of tax return information by preparers.

<sup>35</sup> However, because the IRS rarely assesses preparer penalties, the actual best sign of a wayward preparer in the current environment may be taxpayer penalties.

The National Taxpayer Advocate requests that the IRS work closely with her office on any proposed changes to bypass rules. The IRS needs to respect Forms 2848 on file and should not be able to deal directly with taxpayers on anything other than *de minimis* matters, such as changing an address, inquiring about the status of a refund, or other minor account issues. Without the protection of the existing bypass rules, taxpayers could unwittingly enter into binding arrangements with the IRS that are not in their best interests.

## Recommendations

The National Taxpayer Advocate recommends that the IRS take the following steps to improve the enforcement of preparer penalties:

- In connection with the Servicewide Return Preparer Strategy, create a Return Preparer Executive Steering Committee to provide an oversight function as well as promote coordination of preparer service and enforcement programs throughout the organization.
- Expend resources to collect assessed penalties under IRC §§ 6694 and 6695. The IRS should not focus on the amount of the penalties, due to the cascading effect such collection efforts have on the compliance of the preparers' present and future clients.
- Enforce the penalties imposed under IRC §§ 6713 and 7216. The IRS should give utmost priority to the confidentiality of tax return information, and by enforcing these penalties will ensure that preparers appropriately use and disclose such information. Accordingly, the IRS should raise awareness by incorporating detailed information into the appropriate training materials and IRMs on the identification of violations and referrals of potential violations.
- Perform tax compliance checks on all individuals listed on ERO applications (including Designated Users) at the time of the application as well as on a periodic basis. If the IRS finds outstanding preparer penalty amounts, even relatively small ones, it should deny the designation or suspend the individual's ability to participate in the *e-file* program, as applicable, if the individual fails to cure the problem after an appropriate time. In addition, the IRS needs to verify the status of applicants claiming to be not-for-profit services.
- Include the topic of taxpayer representation and bypass procedures in annual mandatory briefings for all employees.

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#10**Taxpayer Service and Behavioral Research****Responsible Officials**

Mark Mazur, Director, Research, Analysis, and Statistics

Steven T. Miller, Commissioner, Tax Exempt and Government Entities Division

Richard J. Morgante, Commissioner, Wage and Investment Division

Frank Y. Ng, Commissioner, Large and Mid-Sized Business Division

Kathy Petronchak, Commissioner, Small Business/Self-Employed Division

**Definition of Problem**

The IRS has more quality research on taxpayer service at its disposal than ever before. As part of the Taxpayer Assistance Blueprint (TAB), the IRS conducted extensive research on taxpayers' needs, preferences, behavior, and their willingness to use certain services.<sup>1</sup> The National Taxpayer Advocate has also commissioned studies to identify ways to improve the tax system.<sup>2</sup> The IRS now needs to test and apply the findings of these studies.

One way the IRS can implement its current findings and prepare future studies to improve the tax system is by developing a behavioral research lab and exploring different approaches to improving tax morale.<sup>3</sup>

**Analysis Of Problem****Background**

Since the release of the TAB report in April 2006, the IRS has put in place a number of new governance structures to ensure that the recommendations in the report are implemented. The IRS created a Project Management Office within the Wage and Investment (W&I) division that is responsible for carrying out the TAB recommendations.<sup>4</sup> The IRS also established a Taxpayer Service Executive Steering Committee (ESC) to facilitate an IRS-

<sup>1</sup> IRS, *The 2007 Taxpayer Assistance Blueprint Phase 2* at 20-21 (2006) (discussing principle research projects).

<sup>2</sup> *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*, *infra* vol. 2 at 137-182; *IRS Earned Income Credit Audits, A Challenge to Taxpayers*, *infra* vol. 2 at 93-115; Study of Taxpayer Needs, Preferences, and Willingness to Use IRS Services, National Taxpayer Advocate 2006 Annual Report to Congress vol.2; Earned Income Tax Credit (EITC) Audit Reconsideration Study, National Taxpayer Advocate 2004 Annual Report to Congress vol. 2.

<sup>3</sup> Tax morale refers to internal motivations that influence tax compliance. See *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*, *infra* vol. 2 at 139.

<sup>4</sup> Taxpayer Service Program Management Office (TSPMO), *Charter*.

wide approach to taxpayer service, evaluate service-related decisions, and ensure continuity in the process.<sup>5</sup>

### What Can the IRS Learn from Additional Research?

The TAB report contains plans for future research on taxpayer service, including both traditional and more hands-on research conducted through the Taxpayer Assistance Centers (TACs).<sup>6</sup> A new research study sponsored by the National Taxpayer Advocate and completed by Professor Marjorie Kornhauser also adds to the existing data regarding taxpayer behavior.

Professor Kornhauser's study examines the components of tax morale and how it impacts tax compliance.<sup>7</sup> The study also makes recommendations for the IRS aimed at improving tax compliance among individual taxpayers.<sup>8</sup> Tax morale refers to internal motivations that influence tax compliance.<sup>9</sup> One of the study's findings is that procedural fairness or justice is "a major determinant of tax morale."<sup>10</sup> A key component of procedural fairness includes voice, or "participation in the process and belief that authorities 'hear' the individual."<sup>11</sup> The importance of "voice" in the tax process is a critical finding and the IRS can capitalize on this information by allowing taxpayers to have input into the IRS website, IRS products, and the method of delivering those products.

The study also examines how external factors can impact taxpayers' internal motivations. It is important for the IRS to understand the attitudes and motivations of taxpayers in order to create positive attitudes and encourage positive actions. Certain demographic factors can influence tax compliance.<sup>12</sup> Moreover, the way information is communicated can impact taxpayer behavior.<sup>13</sup> By phrasing things positively or negatively, the IRS can thus influence taxpayer behavior.<sup>14</sup> Education can also influence taxpayer behavior by reinforcing fairness in the tax system and social norms.<sup>15</sup>

<sup>5</sup> At its first meeting, the ESC approved the outlines of a research plan for taxpayer service. The proposed research plan is a good first step in continuing the research that started with the TAB.

<sup>6</sup> IRS, *The 2007 Taxpayer Assistance Blueprint Phase 2* at 105-120, 124-126 (2006) (discussing future research initiatives in the TACs and IRS-wide).

<sup>7</sup> See *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*, *infra* vol. 2 at 137-171.

<sup>8</sup> See *Id.* at 158-170.

<sup>9</sup> See *Id.* at 139.

<sup>10</sup> See *Id.* at 149.

<sup>11</sup> See *Id.* Other key components of procedural fairness include neutrality of the decision, belief in the neutrality of the decision-maker, and being treated with respect and politeness. See *Id.*

<sup>12</sup> The demographic factors discussed in the study are gender, age, education, marital status, religion, and income. See *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*, *infra* vol. 2 at 153-155.

<sup>13</sup> See *Id.* at 151-152.

<sup>14</sup> See *Id.*

<sup>15</sup> See *Id.* at 153.



*The information in Professor Kornhauser's study is critical for the IRS because if the IRS can modify its approach to encourage taxpayers to act in certain ways, the IRS can improve voluntary compliance.*

Although available research provides the IRS with insights into taxpayer behavior and ways to affect that behavior, there is still a great deal the IRS can learn. The IRS needs to conduct additional research to understand what motivates taxpayers and how to alter IRS activities to improve taxpayer service and encourage increased compliance.

### Development of a Research Lab

To develop services that meet taxpayers' needs and that taxpayers can use, the IRS should continue its earlier research efforts. Although the TAB and its follow-up research are steps in the right direction, the IRS needs to do more. As recommended in Professor Kornhauser's study on tax morale, the IRS should establish a permanent function – a Behavioral Science Unit (BSU) – devoted to improving voluntary compliance.<sup>16</sup>

A main component of the BSU should be a behavioral research lab.<sup>17</sup> The lab would allow the IRS to conduct in-depth research on taxpayer behaviors and attitudes to improve both taxpayer service and compliance. Among other things, the IRS should use this lab to make the IRS.gov website and all forms and publications more user-friendly.

The research lab should have a full-time staff with expertise in a variety of areas such as economics, psychology, sociology, education, marketing, and moral philosophy.<sup>18</sup> Moreover, the staff should have theoretical, empirical, and practical capabilities to provide the IRS with the expertise necessary to develop and perform studies, evaluate data, and interact with other agencies and the public.<sup>19</sup> By staffing the lab with individuals with a wide breadth of experience, the IRS will create a team capable of designing and implementing innovative and informative research.

By asking taxpayers to come into the lab and use a new form or navigate the website, the IRS can monitor where taxpayers experience difficulty. The IRS can use the information gained through observations to make IRS.gov as well as forms and publications easier to use and navigate. The IRS could also “test” taxpayers to see if they can use IRS publications or other applications to find the information they are looking for. Further, by having

<sup>16</sup> The two other major recommendations from this study were that the IRS should adopt a “tax morale” model of compliance and the IRS should implement educational and media programs based on research findings to encourage voluntary compliance. *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*, *infra* vol. 2 at 158-167. Her Majesty's Revenue and Customs (HMRC) in the United Kingdom already has such a unit.

<sup>17</sup> The IRS currently has the Ogden Usability Lab, however that lab is used mainly for project planning and testing. IRM 2.25.14.5, *IRS - Ogden Usability Services* (Sept. 10, 2004).

<sup>18</sup> See *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*, *infra* vol. 2 at 158-159.

<sup>19</sup> See *Id.*

taxpayers read, apply, and comment on current letters and notices, the IRS can develop correspondence that taxpayers can understand and respond to.

In line with Professor Kornhauser's recommendation regarding improved education and outreach, the IRS can also use the research lab to test the effectiveness of new outreach and education products and campaigns.

In addition, this behavioral lab can assist operating divisions in designing and implementing field tests of new approaches to compliance problems. Such approaches could incorporate service, education, and enforcement components.<sup>20</sup> The establishment of a behavioral science unit will ensure that such projects, regardless of the subject matter or taxpayer population, will be conducted in a scientifically sound manner and the results will be available to the entire IRS for future learning and application.

The existence of a research lab dedicated to testing and enhancing IRS products is key to improving taxpayer service. By applying existing research findings and developing a stronger understanding of taxpayer behavior, the IRS can also improve voluntary compliance. This approach, in the long run, results in fairer and more balanced tax administration.

### IRS Comments

The IRS recognizes that there is a need to improve the quality and quantity of research into the question of how service provision affects taxpayer compliance (including both intentional and unintentional non-compliance). The Taxpayer Assistance Blueprint project has begun the process of assembling what is known in this area and supplementing that work with original survey research focused on the needs and desires expressed by individual taxpayers about the services they would like to be able to access. The President's FY 2008 Budget Request included a \$5 million initiative specifically aimed at improving and understanding the link between provision of services to taxpayers and their impact on taxpayer compliance. This initiative would allow the IRS to embark on a multi-year research agenda that could eventually pay large dividends through improved voluntary compliance.

However, at this stage of development, there is no single approach in this research area that appears superior to other possible approaches. The IRS intends to use available resources to undertake several research projects in FY 2008, with the goal of helping to shape future research endeavors in this area. It would be premature to conclude that establishing a cognitive and applied research lab run by the IRS is the most effective approach to use limited resources.

The "tax morale" hypothesis raised by the National Taxpayer Advocate's report raises some interesting questions about the myriad ways that governmental actions can affect taxpayer

<sup>20</sup> The multi-year EITC Certification Initiative is one example of this approach. See IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005 23* (Oct. 2005).

compliance. The basic insight in the “tax morale” literature is the recognition that taxpayers’ psychological states might affect their willingness to comply with the tax law and, in turn, affect their actual compliance behavior. Unfortunately, empirical data on this linkage is not sufficient to support firm conclusions about steps a tax administration agency might find effective. At this point, the work is merely suggestive of factors that might come into play and how they could be manipulated to improve taxpayer compliance. Much more research in this area is needed before policymakers can be confident in the implications.

In summary, the IRS’s response to the National Taxpayer Advocate raising this issue is to acknowledge that more research is needed on the link between provision of taxpayer service and subsequent taxpayer compliance. The IRS intends to begin research in this area as resources are available. The results from these research efforts will shape the future research agenda, enabling the IRS to concentrate on the most promising areas. These results may or may not validate the proposal that utilizing a cognitive and behavioral lab would be an effective strategy for advancing research in this area.

### Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS recognizes the need to improve the quantity and quality of research on how service impacts taxpayer compliance. The National Taxpayer Advocate is not suggesting that there is a single superior approach to this type of research. We are also aware of the IRS’s limited resources and the desire to obtain the most valuable and relevant information given the available funding.

Traditional research methods can only reveal so much about taxpayer behavior, and have yet to produce concrete recommendations for how the IRS can improve voluntary compliance. The National Taxpayer Advocate recommends that the IRS think “outside the box” of traditional research and engage in the types of research that can yield immediate and measurable improvements to taxpayer service and potentially to voluntary compliance. The IRS has undertaken such research as part of the Facilitated Self Assist Research Project in Taxpayer Assistance Centers.<sup>21</sup> The development of a behavioral and cognitive research lab would take this type of research IRS-wide to identify ways to improve both taxpayer service and voluntary compliance. It would supplement, rather than supplant, current research initiatives and provide a much-needed taxpayer-focused dimension to analysis of tax administration and tax compliance.

<sup>21</sup> For additional information, see Most Serious Problem, *Service at Taxpayer Assistance Centers*, *infra*.

## Recommendation

The National Taxpayer Advocate recommends that the IRS enhance its existing research capacities by developing an applied research lab and exploring different approaches to improving tax morale.

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## Service At Taxpayer Assistance Centers

### Responsible Official

Richard J. Morgante, Commissioner, Wage and Investment Division

### Definition of Problem

The IRS's Taxpayer Assistance Blueprint (TAB) report was intended to offer research-based models to help the IRS make decisions about taxpayer service, including the delivery of face-to-face service.<sup>1</sup> If used correctly, the TAB research can be an important first step toward improving taxpayer service. Because of the TAB, the IRS now knows more than ever about taxpayer needs, preferences, and willingness to use services. We know there is a segment of the population that will always have a need for face-to-face service to help them comply with IRS tax laws.<sup>2</sup> Despite this knowledge and research, taxpayers who visit Taxpayer Assistance Centers (TACs), the IRS's primary method of delivering face-to-face service, continue to experience difficulties that include:

- The location of TACs;
- TAC staffing and the availability of services;
- Return preparation;
- Obtaining return and account transcripts;
- Making payments; and
- Out-of-scope tax law questions.

### Analysis of Problem

#### Background

The TAB: Phase 2 details a five-year strategic plan to determine how best to provide service to taxpayers in the future. This plan includes a step-by-step process to make future decisions about the types of services, locations of offices, and methods or channels for delivering services. The Taxpayer Service Executive Steering Committee, of which the National Taxpayer Advocate is a member, provides oversight for IRS decisions about service.<sup>3</sup>

<sup>1</sup> IRS, *Taxpayer Assistance Blueprint: Phase 2* (Apr. 17, 2007).

<sup>2</sup> National Taxpayer Advocate 2006 Annual Report to Congress vol. 2.

<sup>3</sup> IRS, *Taxpayer Services Revised Committee Charter*, (revised Oct. 11 2007); *IRS TAB Guiding Principles*, (revised Oct.11 2007); *Taxpayer Assistance Blueprint: Phase II* (Apr. 17, 2007); Taxpayer Service Executive Service Committee, 127-128. The Taxpayer Service Program Management Office is responsible for overall facilitation, coordination and integration of service initiatives.

Many of the TAB's recommendations are predicated on existing IRS strategies, including increasing the use of electronic services throughout the IRS.<sup>4</sup> The evolution of the personal computer and the ability to connect with the government and private sector through the Internet have allowed many transactions, including some with the IRS, to take place electronically. The IRS, citing greater efficiency, has consistently sought to take advantage of the cost-effectiveness of electronic services.<sup>5</sup> However, a recent study by Russell Research shows that about 32 percent of taxpayers who do not file their tax returns via some electronic method will not file electronically in the future, and 46 percent feel that mailing a paper return is safer and more reliable than electronic filing.<sup>6</sup> Taxpayers cite security as an important factor for their not using the Internet. In fact, the IRS Oversight Board study found that 73 percent of taxpayers surveyed did not feel secure sharing personal financial information over the Internet, even with a government agency.<sup>7</sup> A portion of the taxpayering public continues to prefer face-to-face service, which the IRS's 2007 Field Assistance Program Letter says the IRS will continue to provide.<sup>8</sup> The question is whether the IRS will provide face-to-face services that prioritize the needs of taxpayers.

### What Should Shape Taxpayer Service?

Taxpayer service should be shaped, in large part, by taxpayer needs, preferences, and the taxpayer's willingness to use services.<sup>9</sup> The National Taxpayer Advocate has continually advocated that the IRS should provide services that meet taxpayers' needs and enable taxpayers to comply with their tax law obligations.<sup>10</sup> Taxpayer needs and preferences should be substantial drivers in taxpayer service decisions to ensure that taxpayers will use available services.<sup>11</sup> A taxpayer's willingness to use a certain service, such as the Internet, phone or face-to-face services, will influence the service a taxpayer decides to use. Similarly, factors such as language skills, age, income, literacy, and disability will impact taxpayer preferences.<sup>12</sup>

<sup>4</sup> IRS, *Taxpayer Assistance Blueprint: Phase 2* 10 (Apr. 17, 2007).

<sup>5</sup> IRS Wage and Investment Division, Electronic Tax Administration Statistics, *Program Summary Dashboard*, at <http://eta.hq.irs.gov/eta/dashboard/dashboard%20summary/&&default.asp>. The number of taxpayers who chose to file their Forms 1040 electronically each year has increased from 72,507,887 for tax year (TY) 2006 to 79,011,996 for TY 2007, an 8.97 percent gain (as of 10/8/07). At the same time, the number of direct deposit refunds rose by 7.93 percent from 56,552,000 in 2006 to 61,037,000 in 2007. However, Free File numbers decreased from TY 2006 by 1.10 percent.

<sup>6</sup> IRS, Russell Research, *2007 Taxpayer Segmentation Study* 33 (Apr. 9 2007).

<sup>7</sup> IRS Oversight Board Taxpayer Customer Service and Channel Preference Survey Special Report 19 (Nov 2006).

<sup>8</sup> Field Assistance Program Letter 07, *A Word About Our Future* 4 (Oct. 2006).

<sup>9</sup> For a detailed discussion of taxpayer needs, preferences, and willingness to use, see National Taxpayer Advocate 2005 Annual Report to Congress 6-13; National Taxpayer Advocate 2006 Annual Report to Congress vol. 2, 1-14.

<sup>10</sup> For a detailed discussion of taxpayer needs, compliance and needed research, see National Taxpayer Advocate 2005 Annual Report to Congress 13-15. National Taxpayer Advocate 2006 Annual Report to Congress vol. 2, at 1-14, National Taxpayer Advocate 2004 Annual Report to Congress 49, *Internal Revenue Service FY 2008 Budget Request: Hearing Before the Subcomm. on Financial Services and General Government, S. Comm. on Appropriations, 110<sup>th</sup> Cong., 1<sup>st</sup> Sess (May 9, 2007)* (statement of Nina E. Olson, National Taxpayer Advocate) 7-10.

<sup>11</sup> National Taxpayer Advocate 2006 Annual Report to Congress vol. 2.

<sup>12</sup> *Id.*

The TAB recommends moving taxpayers with a preference and willingness for electronic services away from the TACs.<sup>13</sup> However, studies show that when contacting the IRS, taxpayers overwhelmingly prefer personal assistance (phone or an IRS office). Taxpayers prefer visiting the IRS in person over every other method except using the telephone.<sup>14</sup> A Pew Internet & American Life study found that more than 25 percent of all American adults do not use the Internet. Age, disability, ethnicity, race, and income levels all affect Internet usage.<sup>15</sup> Downloading or printing a government form is one of the five most common tasks performed on federal government websites, yet only 20 percent of U.S. households downloaded or printed forms from federal government sites in 2006.<sup>16</sup>

Studies indicate that certain population segments have special needs. TAB research, based on the Oversight Board Survey, indicates that low income, Limited English Proficiency (LEP), and elderly taxpayers have a higher preference for TAC channels and a lower preference for web channels than taxpayers as a whole.<sup>17</sup>

The first of the baby boom generation will turn 65 in 2011, and by 2030 baby boomers aged 66-84 will account for 20 percent of the U.S. population.<sup>18</sup> With this in mind, the IRS needs to begin new research to determine the segment of this population that will not use the Internet, as well as the growth of other population segments that require face-to-face service.

The Taxpayer Advocacy Panel (TAP) conducted studies in early to mid 2007 about the customer service experiences of taxpayers, and IRS employees' satisfaction with the level of service they are able to provide to taxpayers visiting a TAC. The TAP customer survey gathered information about why the taxpayer was visiting the TAC and whether the taxpayer was satisfied with the service received. Taxpayers were also asked if they visited the TAC office for a service that was not available, why they chose to visit the TAC instead of using a different IRS service, and to provide some demographic information. The TAP employee study was designed to gather information from employees working in TAC offices about the service they provide taxpayers. Employees supplied feedback on different aspects of their jobs and rated their satisfaction with the level of service TAC customers receive. The TAP studies will provide IRS with information useful in improving not only TAC services, but other taxpayer services as well.

<sup>13</sup> IRS, *Taxpayer Assistance Blueprint: Phase 2, Executive Summary* 10 (Apr. 17, 2007).

<sup>14</sup> 2006 Oversight Board Service Channels Study – Questions 14 & 15 – taxpayers' first and second service channel choice.

<sup>15</sup> Only 53 percent of adults living in households with less than \$30,000.00 in annual income go online. Pew/Internet, *Pew Internet & American Life Project, Internet Penetration and Impact*, 4 (Apr. 2006). Sixty-eight percent of adults over 65 do not access the internet. Seventeen percent of Americans are living with a disability or a chronic disease; only 51 percent of this group goes online. Only one third of Hispanic-Americans go online. Pew/Internet, *Pew Internet & American Life Project, Internet Usage and Trends-Through the Demographic Lens* 1-5 (Nov. 2006).

<sup>16</sup> Forrester Research Inc., *eGovernment Adoption Levels: 2006 1-2* (September 2006).

<sup>17</sup> Internal Revenue Service Oversight Board, *Taxpayer Customer Service and Channel Preference Survey*, Question 17 (Apr. 2006).

<sup>18</sup> Wage and Investment Office of Research, *Baby Boomers and Seniors: e-Filing & Compliance Outreach* 21-23 (June 2006).



There is a segment of the taxpaying population that will likely always need face-to-face service.<sup>19</sup> If the IRS does not commit to providing this service in the future, taxpayers who need personal service may be forced to turn to paid help or fall into noncompliance. As taxpayers' needs and technology change, the role of face-to-face service may change as well. However, the commitment to providing some form of this service should be present to reassure taxpayers that the IRS will continue to meet their needs.

### **What Are the Current Problems in the TACs?**

The failure of the IRS to commit to face-to-face service with regard to return preparation, coupled with the reduction in taxpayer service over the past few years,<sup>20</sup> particularly in the TACs, has created problems and delays for both taxpayers and the IRS. The current TAC offices, locations, and availability of services, along with IRS policies, have caused difficulties for taxpayers needing TAC assistance, in return preparation, return transcripts, payments, and tax law questions.

### ***TAB Data Indicates that TAC Service Should Be Expanded – Not Decreased***

As a result of the TAB, the IRS formed a team of employees from various functions, including TAS, to validate the TAC information in the TAB Phase II Report. The team reviewed the accuracy of data for all 401 TAC offices, including space, staffing, equipment, and services. The W&I Research component of the team developed a tool for Field Assistance personnel to use in making decisions about their TAC operations.<sup>21</sup> The outcome will be a ranking of TACs that will allow the IRS to apply additional information available at local levels to decide whether the operating division level recommendation makes sense.

This model was not designed to consider the possibility of the IRS adding TAC locations, even though research from the TAB already demonstrates that TAC coverage across the United States is insufficient. For example, current TACs are within 30 minutes drive time of only 60 percent of the United States population.<sup>22</sup> However, to provide face-to-face service that customers need and will use, the IRS should not predetermine that the number of TACs should be reduced or increased without conducting additional research. In fact, some TACs may need to relocate to better serve taxpayers, and certain TACs may need to offer services that are not required in others.

### ***Reduced TAC Staffing Affects Service Availability***

The reduction of taxpayer service at the TACs is partially due to the lack of adequate staffing and availability of services. There are 401 TAC offices throughout the U.S. and Puerto

<sup>19</sup> IRS, Russell Research, *2007 Taxpayer Segmentation Study* 33 (Apr. 9 2007).

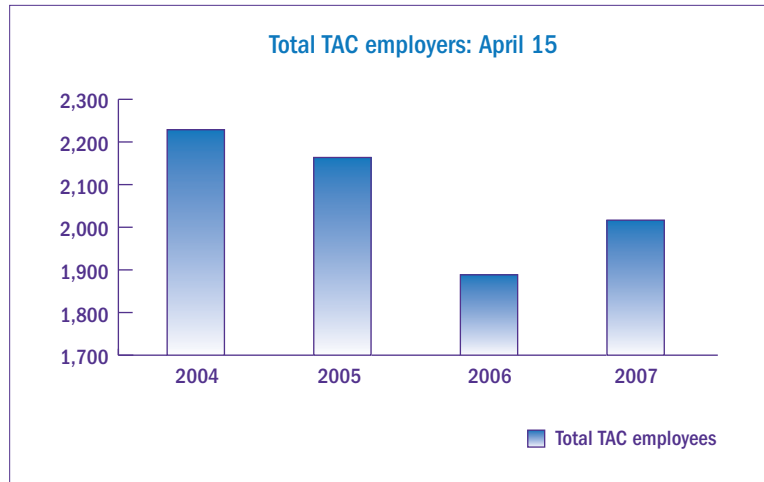
<sup>20</sup> For a detailed discussion on the reduction of taxpayer service, see 2004 National Taxpayer Advocate Annual Report to Congress 4-5.

<sup>21</sup> IRS, *Taxpayer Assistance Blueprint: Phase 2* (Apr. 17, 2007).

<sup>22</sup> *Id.* at 192.

Rico.<sup>23</sup> Chart 1.11.1 illustrates how TAC staffing levels have changed over the past four years.

**CHART 1.11.1, TAC Staffing Level: April 15 Of Each Year<sup>24</sup>**



The nine percent decline in staffing from FY 2004 to FY 2007<sup>25</sup> has left the IRS unable to adequately staff all TAC offices, which in turn has affected operating hours. Only 55 percent of TACs are open for business for 36 to 40 hours per week.<sup>26</sup> The rest are open 35 hours per week or less. Three offices are open only eight hours or less per week.<sup>27</sup>

If a taxpayer is able to visit a TAC during business hours, he or she may still experience difficulty obtaining service. Less than 25 percent (89 offices) provide the full range of services listed online. Because the availability of services differs by office, a taxpayer must visit the TAC, check the IRS website, or call the local phone number simply to determine if the office provides a particular service.

To address the limited staffing in TACs, the IRS has begun experimenting with a Facilitated Self Assistance Research Project in certain TACs.<sup>28</sup> The IRS will set up these workstations for taxpayers to use with employee assistance, and will provide person-to-person service

<sup>23</sup> As of May 2007, the TAC in Desoto, Texas was designated as closed dropping the total count of open offices from 401 to 400. IRS, *Contact My Local Office, Face-to-face Tax Help* at <http://www.irs.gov/localcontacts/index.html>.

<sup>24</sup> Information received from IRS Field Assistance, September 2007. Total TAC employees: FY 2004 2,230; FY 2005 2,160; FY 2006 1,888, FY 2007 2,027, Biweekly pay periods 9 & 10, April 15. "Biweekly pay period" is the two-week period for which an employee is scheduled to perform work.

<sup>25</sup> *Id.*

<sup>26</sup> Fifty-five percent translates to 219 offices, including the only TAC in Puerto Rico. IRS, *Contact My Local Office, Face-to-face Tax Help* at <http://www.irs.gov/localcontacts/index.html> (May 2007).

<sup>27</sup> Those offices are Fort Dodge, IA.; State College, PA.; and Keene, NH. IRS, *Contact My Local Office, Face-to-face Tax Help* at <http://www.irs.gov/localcontacts/index.html>.

<sup>28</sup> IRS, *Taxpayer Assistance Blueprint: Phase 2 113*.

if the taxpayer insists. The National Taxpayer Advocate is supportive of these models and the migration of taxpayers to services that meet their needs. Some taxpayers are willing to use the Internet for certain activities that are not account related.<sup>29</sup> About 50 percent of taxpayers are willing to use the irs.gov website to obtain tax law information, forms, or publications.<sup>30</sup> However, prematurely moving taxpayers to certain service channels without first determining taxpayers' needs, preferences, and ability to use these channels is a concern. There is no data to support the conclusion that many taxpayers who travel to TACs could resolve their issues online.<sup>31</sup> Moreover, when taxpayers are already having difficulty obtaining service at TACs, we are concerned that IRS employees will assume the taxpayers can solve their problems through "self-assistance."

### *Return Preparation Assistance Has Been Reduced*

Over the past few years, the IRS has restricted taxpayers' ability to obtain return preparation at a TAC. A taxpayer requesting this assistance must meet specific guidelines<sup>32</sup> and have an appointment at a TAC – which the taxpayer cannot make by phone, because the IRS requires taxpayers to set up appointments in person.<sup>33</sup> The TACs generally schedule appointments within five days, but the number of appointments available is limited.<sup>34</sup> Taxpayers must therefore visit the TAC office at least twice – once to make an appointment (if available) and once to have the return prepared. Additionally, if the taxpayer is filing a current year, married filing joint return, which require electronic filing at the TACs, both parties must be present during the return preparation. If one or both spouses work, this requires them to take time off to travel to the TAC.<sup>35</sup>

The current IRS policies regarding return preparation create an unnecessary burden for taxpayers, many of whom may not be able to afford a paid return preparer and are forced to visit the IRS office numerous times. This burden is evident in an issue that was elevated to TAS via a Systemic Advocacy Management System (SAMS) submission. During the 2006 filing season, more than 20 taxpayers were told, after standing in line at a TAC for several hours for return preparation service, that all appointments for that day and the next

<sup>29</sup> IRS Oversight Board, *2006 Service Channels Survey*, Questions 12j & r: 68.2 – 74.2 percent of taxpayers stated they agreed (agreed or strongly agreed) with the statement "I like getting help in-person with my tax questions", and 60.3 – 66.6 percent agreed (agreed or strongly agreed) that they would check the status of their refund themselves if the IRS provided tools that would allow this.

<sup>30</sup> Opinion Survey of Taxpayer Resources and Services, W&I Research, 2006 – Question 8: 48.2 percent – 50.8 percent of taxpayers are willing to use irs.gov to obtain tax forms and publications. Similarly, 45.9 – 48.5 percent of taxpayers are willing to obtain tax law information from IRS.gov.

<sup>31</sup> Below is an example of the type of assumption made in the TAB. *Taxpayer Assistance Blueprint: Phase 2* 113 (Apr. 17, 2007) concluding:

Recognizing that many TAC users seek assistance in a TAC for services they could access via telephone or the irs.gov, the Facilitated Self Assistance Research Project will provide taxpayers coming into a TAC with the option to use self-assisted service to resolve the issue.

<sup>32</sup> IRM 21.3.4.10.2. (Apr. 1, 2007) Individuals requesting return preparation must meet the following criteria: Income of \$39,000 or less and for joint returns both spouses must be present. Tax preparation is offered for Forms: 1040EZ, 1040EZ-T, 1040A with schedules 1, 2, 3 and EIC, Form 1040 with schedules A, B, C-EZ, EIC, R, SE, Form 2441 Dependent Care, Form 8863 Education Credit, Form 8839 Adoption Credit, Form 8812 Additional Child Tax Credit, Form 8880 Qualified Retirement Savings Contribution Credit, Form 1040ES, Form 1040X, Form 2290, Form 8913 Credit for Federal Telephone Excise Tax and Form 8888 Direct Deposit of refund.

<sup>33</sup> IRM 21.3.5.4.4.1. (Nov. 9, 2006).

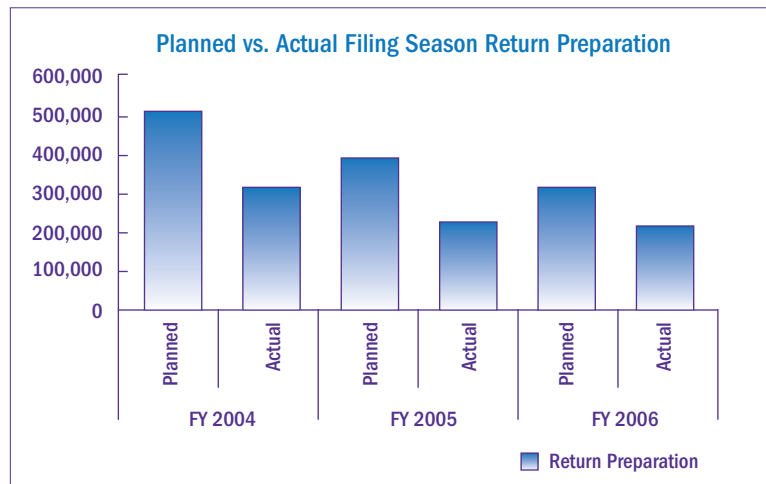
<sup>34</sup> IRM 21.3.4.10.5 (1) (Apr. 1, 2007).

<sup>35</sup> IRM 21.3.4.10.2. (Apr. 1, 2007).

five business days were full.<sup>36</sup> The TAC employees advised taxpayers that they could return another day to make appointments but there was no guarantee that any would be available.

The appointment policy changes likely contributed to a reduction in the number of returns prepared in the TACs. As the chart below demonstrates, the reduction of levels of return preparation is also lower even than the reductions planned by the IRS.<sup>37</sup>

**CHART 1.11.2, Taxpayer Service Planned vs. Actual Return Preparation Filing Seasons 2004-2006<sup>38</sup>**



Tax return preparation decreased by about 29 percent from 2004 to 2006.<sup>39</sup> At the same time the IRS is limiting return preparation, it is encouraging TAC employees to refer taxpayers to volunteer preparation sites or paid practitioners.<sup>40</sup> Although programs such as Volunteer Income Tax Assistance (VITA) provide a very valuable service, they are not a substitute for the IRS. The IRS should not pass off responsibility for return preparation to volunteers, which exist to supplement the services provided by the IRS. Although TAC return preparation has substantially decreased since fiscal year 2004, the number of returns prepared by VITA and Tax Counseling for the Elderly (TCE) sites increased by about 36 percent from FY 2004 to FY 2007.<sup>41</sup> Nonetheless, there are limitations on what we can expect from seasonal volunteers as compared to full-time, professional IRS employees. Moreover, given the great range of services that TACs provide, a visit to a TAC for return

<sup>36</sup> Systemic Advocacy Management System (SAMS) issues I0024782, I0024783, I0026711.

<sup>37</sup> IRS, *Wage & Investment Strategy and Program Plan FY 2007-2008* 46, at [http://win.web.irs.gov/Strategy/stratdocs/SPP\\_FY2007-FY2008.pdf](http://win.web.irs.gov/Strategy/stratdocs/SPP_FY2007-FY2008.pdf).

<sup>38</sup> Data for actual return preparation submitted by Wage and Investment Operating Division, July 2007; Data for planned return preparation, *Wage & Investment Internal Strategy and Program Plan FY 2005-2006* 36 at [http://win.web.irs.gov/Strategy/stratdocs/strategy\\_program\\_plan05-06.pdf](http://win.web.irs.gov/Strategy/stratdocs/strategy_program_plan05-06.pdf).

<sup>39</sup> Data for actual return preparation submitted by Wage and Investment division, July 2007 (308,356 -220,004 = 88,352/308,356 = 28.7 percent).

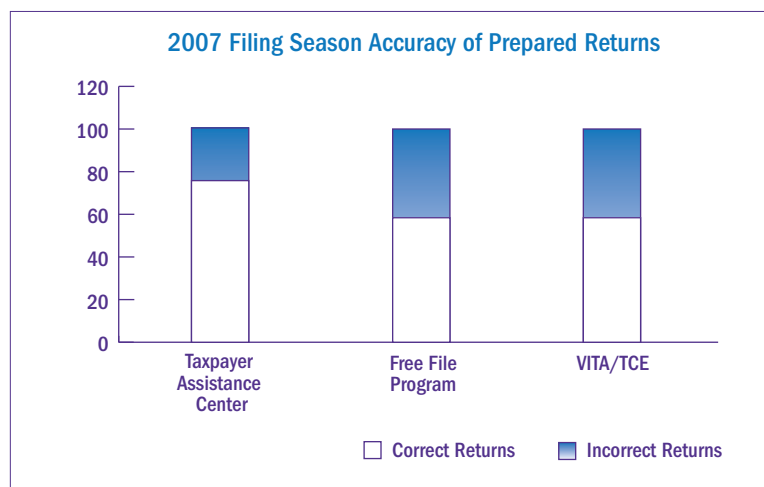
<sup>40</sup> IRM 21.3.4.10.5 (Apr. 1,2007).

<sup>41</sup> Data provided by the Operating Division, (June 2007). Total Returns VITA & TCE FY 2004, 1,934,512, FY2005, 2,106,164, FY2006, 2,263,602, FY2007 2,622,522. 2006 return data is cumulative through Sept. 30, 2006; 2007 return data is cumulative through June 10, 2007.

preparation is not only an opportunity to satisfy the preference of a taxpayer, but also an opportunity for the IRS to educate and help correct the taxpayer's other problems.

The IRS's move to refer taxpayers to volunteer preparers is particularly disappointing in light of research reflected in the chart below that suggests that IRS-prepared returns are more accurate than others.

**CHART 1.11.3, 2007 Filing Season Percent of Correct/Incorrect Returns Prepared<sup>42</sup>**



Although VITA sites have experienced low accuracy rates for return preparation since 2004, their accuracy improved from FY 2004 to FY 2007.<sup>43</sup> However, the IRS consistently prepares returns more accurately than volunteers, Free File users, or other taxpayers who prepare their own returns.<sup>44</sup> Data also tells us that taxpayers with incomes lower than \$35,000 per year believe their returns would be more accurately prepared if they received help from the IRS.<sup>45</sup>

A previously conducted study that examined the relationship between IRS return preparation and compliance over a ten-year period showed an increase in the number of returns prepared by the IRS correlates with substantial improvement in compliance among filers of individual returns. Taking into account the indirect effects of IRS return preparation, the

<sup>42</sup> Treasury Inspector General For Tax Administration, Ref. No. 2007-40-164, *The Internal Revenue Service Provides Helpful Tax Law Assistance but Still Has Problems With Tax Return Preparation Assistance* 11 (Aug. 2007). Treasury Inspector General For Tax Administration, Ref. No. 2007-40-137, *Accuracy of Volunteer Tax Returns Is Improving, but Procedures Are Often Not Followed* 5 (Aug. 2007). The TIGTA audit did not include the TCE program until FY 2007.

<sup>43</sup> Treasury Inspector General For Tax Administration, Ref. No. 2007-40-164, *The Internal Revenue Service Provides Helpful Tax Law Assistance but Still Has Problems With Tax Return Preparation Assistance* 5 (Aug. 2007). VITA accuracy has improved from 0 percent in FY 2004 to 56 percent in FY 2007.

<sup>44</sup> *Id.*

<sup>45</sup> IRS Oversight Board, *2006 Service Channels Survey*, 12 & D5: 73.5 – 84 percent of taxpayers earning less than \$35,000 like getting help in person from the IRS compared with 64.5 – 71.7 percent of those with incomes of \$35,000 or more. Similarly, more low income taxpayers would visit an IRS office if it were nearby (55.7 – 68.2 percent) than higher income taxpayers (40 – 47.4 percent). More of this group (33 – 45.9 percent) believes their tax return would be more accurate if they received IRS help than their wealthier counterparts (23 – 29.7 percent).

study estimated the return on investment for each dollar the IRS spent on return preparation was 396:1.<sup>46</sup>

### *Policies on Return and Account Transcripts are Restrictive*

Until recently, taxpayers could obtain account records or return transcripts through several different methods, including calling the IRS toll-free number, filing a Form 4506-T, Request for Transcript of Tax Return, or by visiting a TAC.<sup>47</sup> All TAC offices have access to the IRS Transcript Delivery Service (TDS) which can provide immediate access to taxpayer account information and return transcripts. The IRS's explanation for reducing services is that due to reduced staff and funding and increased bulk requests from mortgage institutions,<sup>48</sup> TACs stopped providing transcripts to all taxpayers October 1, 2003,<sup>49</sup> and now offer the service only for current year tax returns and in hardship and emergency situations.<sup>50</sup> The IRS's definition of emergency often does not correspond with taxpayers' definition. Emergency exceptions are limited to situations where the taxpayer has documentation for the following situations:

- Proof of an immigration services appointment within two weeks of the request;
- An airline ticket indicating a departure from the United States within the same timeframe;
- A need to prove eligibility for medical assistance; or
- Natural disaster.<sup>51</sup>

Taxpayers claiming a hardship exception must demonstrate why they are unable to wait the normal processing times.<sup>52</sup> The Internal Revenue Manual (IRM) indicates hardship exceptions "should be rare" and require managerial approval.<sup>53</sup>

Current Internal Revenue Manual (IRM) guidelines regarding emergency and hardship exceptions are not sufficient to meet the needs of taxpayers, nor are TAC employees always following the IRM guidelines regarding return transcripts. One example of the problems with obtaining transcripts comes from a TAS office, where a taxpayer went to a TAC to request a return transcript. The taxpayer was scheduled for surgery the next day and needed

<sup>46</sup> IRS Pub. 1916, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness* 41 (Oct. 1996).

<sup>47</sup> IRM 21.3.4.14.4 (Apr. 1. 2007) All records, except a copy of a return, will be provided by the IRS. The taxpayer must request a transcript in writing from the Return and Income Verification Services (RAIVS) unit via a Form 4506T. The taxpayer should receive the transcript in 30 days using this method. Taxpayers may also call the toll-free number and request a faxed transcript which they should receive within 48 hours, or the taxpayer may have it the transcript mailed to their "record of residence" within ten days. The "record of residence" is the address that is on the IRS account for that taxpayer.

<sup>48</sup> Data provided by the Wage and Investment Division (Sept. 9, 2007).

<sup>49</sup> IRS Field Assistance Newsletter, Congressional Update, *Get Copies of Tax Return Information In Two Easy Ways* (2002).

<sup>50</sup> IRM 21.3.4.14.4 (Apr. 1. 2007).

<sup>51</sup> *Id.* Emergency exceptions do not require managerial approval.

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

a copy of a transcript to prove he was financially eligible to receive financial assistance for the operation. The TAC employee indicated that this was not an emergency and the taxpayer would receive his transcript in two weeks. The TAS office immediately provided the transcript.<sup>54</sup> This example demonstrates that the current IRS hardship procedures for receiving transcripts are so limited as to provide no service at all. Taxpayers who need transcripts for court proceedings, medical procedures, or student loans are being turned away and are increasingly coming to TAS instead, for assistance that the IRS should be providing.<sup>55</sup>

Even standard IRS policies regarding transcripts cause an excessive burden on taxpayers in terms of time.<sup>56</sup> Although all TACs have immediate access to transcripts, the offices instruct taxpayers to fill out and mail in a form, and wait weeks; or to call the toll-free number, in which case the transcript can only be mailed to their address of record.<sup>57</sup> The “address of record” is the address in IRS records for that particular taxpayer, which is most likely the address on the last return the taxpayer filed, and may no longer be correct. Yet, a TAC employee, after verifying the taxpayer’s identity, can provide an account transcript with minimal time and effort.

### *Out-of-Scope Guidelines Do Not Meet Taxpayer Needs*

The National Taxpayer Advocate has repeatedly raised concerns about the increasing number of issues the IRS has declared “out-of-scope” in TACs.<sup>58</sup> Tax assistants are trained only to answer questions about specific topics. The topics they cannot address are called “out-of-scope” questions.<sup>59</sup> Limiting the issues that TAC employees can address reduces the level of service available to taxpayers.<sup>60</sup> For example, despite the number of taxpayers in certain states with income from farming, the National Taxpayer Advocate received a complaint at a taxpayer town hall meeting in Fargo, North Dakota, that questioned why Schedule F, the form used to report farming income and expenses, is considered out-of-scope at IRS walk-in sites. A review of IRS policies confirms that such issues are indeed out-of-scope.<sup>61</sup> Also,

<sup>54</sup> Taxpayer Advocate Management Information System (TAMIS) (FY 2007).

<sup>55</sup> *Id.*

<sup>56</sup> Form 4506T, (Revised April 2006). Absent an emergency or hardship exception, a taxpayer approaching a TAC and wishing to receive account or return transcript is provided a Form 4506T *Request for Transcript of Tax Return*. When submitting this form, the taxpayer should receive account transcripts within 30 days.

<sup>57</sup> IRM 21.1.3.9 (Apr. 27, 2007).

<sup>58</sup> National Taxpayer Advocate 2004 Annual Report to Congress 19. *Internal Revenue Service FY 2008 Budget Request: Hearing Before the Subcomm. on Financial Services and General Government, S. Comm. on Appropriations*, 110<sup>th</sup> Cong., 1<sup>st</sup> Sess (May 9, 2007) (statement of Nina E. Olson, National Taxpayer Advocate).

<sup>59</sup> IRM 21.3.4-1 (Feb. 16, 2007). TACs rely on information published in the Publication Method Guide (PMG), which outlines issues that are considered out of scope.

<sup>60</sup> National Taxpayer Advocate 2004 Annual Report to Congress 12. *Internal Revenue Service FY 2008 Budget Request: Hearing Before the Subcomm. on Financial Services and General Government, S. Comm. on Appropriations*, 110<sup>th</sup> Cong., 1<sup>st</sup> Sess (May 9, 2007) (statement of Nina E. Olson, National Taxpayer Advocate).

<sup>61</sup> IRM 21.3.4-1 (Feb. 16, 2007). TACs rely on information published in the Publication Method Guide (PMG), which outlines issues that are considered out-of-scope.



because topics actually considered in-scope are not listed on IRS.gov, taxpayers may needlessly travel to TACs to ask questions that the website could answer.<sup>62</sup>

One reason the IRS maintains a geographic presence is to assist taxpayers who may have location specific needs. Questions about farming may be out-of-scope in New York City, where complex financial reporting questions may be routine, but in Fargo, North Dakota, it is fair to expect that farming questions are appropriate.<sup>63</sup> The IRS needs to geographically assess and target its assistance to taxpayers.

### *TAC Payment Acceptance Policy Does Not Encourage Compliance*

In 2003, there were more than 10 million American households, representing upwards of 65 million individuals, outside of the traditional banking environment.<sup>64</sup> It is therefore understandable that many of these taxpayers may visit TACs to make payments in person. Most TAC offices accept cash payments from taxpayers who are unable to obtain a check or money order.<sup>65</sup> However, 22 percent of TAC offices do not accept cash,<sup>66</sup> and in those that do, the employees must still convert the payment to a bank draft or money order.<sup>67</sup> The burden is then placed on the taxpayer who must travel to another facility and pay for a money order, while daily interest is accruing on the account. This is particularly burdensome in TACs with only one or two employees. The IRS is testing a kiosk that would allow a taxpayer to convert cash to a money order without having to leave the TAC.<sup>68</sup> If successful, these kiosks could reduce burden on both taxpayers and TAC employees. However, significant payment issues continue at TACs, for example:

A certified public accountant (CPA) visited a TAC to make a non-cash payment of two million dollars. Although the irs.gov website indicates all TAC offices in this particular state accept payments, the TAC employee would not accept the payment. The CPA then mailed the payment to the IRS which resulted in a late payment. The result was that the taxpayer was assessed additional interest of \$30,000.<sup>69</sup>

<sup>62</sup> IRS, *Contact My Local Office, Face-to-face Tax Help* at <http://www.irs.gov/localcontacts/index.html>.

<sup>63</sup> For example, North Dakota has nine percent of the total United States population employed in agriculture versus New York (state) with only 0.60 percent. U.S. Census Bureau, *American FactFinder*, Custom Table at <http://factfinder.census.gov>. Agriculture means farming, forestry, fishing and hunting and mining.

<sup>64</sup> Federal Deposit Insurance Corporation, *"Tapping the Unbanked Market"* Symposium at <http://www.fdic.gov/consumers/community/unbanked/tumtranscript.html#silver> (Nov. 5, 2003).

<sup>65</sup> IRM 21.3.4.7.2 (Jan. 10, 2007).

<sup>66</sup> IRS, *Contact My Local Office, Face-to-face Tax Help* at <http://www.irs.gov/localcontacts/index.html>.

<sup>67</sup> IRM 21.3.4.7.2.3 (Jan. 10, 2007).

<sup>68</sup> Information received from Field Assistance July, 2007. IRS Wage and Investment FY 2008 Strategic Planning Plan, October, 2007, "In FY 2008, Field Assistance will pilot the Self Service Cash Conversion (SSCC) kiosks in two of the ten TACs with the greatest volume of cash transactions, Detroit, MI and Birmingham, AL. The kiosks will enable customers to convert cash into a money order, which will be tendered as payment for their federal taxes. Field Assistance will conduct an analysis of the pilot in FY 2008 to determine the feasibility of deployment in other TACs. If the pilot results are successful and funding is available, in FY 2009, we will deploy to the remaining eight TACs with the greatest volume of cash transactions."

<sup>69</sup> Systemic Advocacy Management System (SAMS) issue I0027662.

## Conclusion

The TAB is an important first step in developing a long-term strategy for taxpayer service. The significance of the TAB is that IRS is viewing service from the taxpayer's perspective, instead of solely from the viewpoint of cost efficiency in tax administration. As a result, the IRS knows more about taxpayers' needs, preferences, and willingness to use specific channels of service. In the TAB, the IRS committed to continue research concerning service preferences, taxpayer segments, and a marketing plan for the TACs.

Notwithstanding the TAB, face-to-face services in the TACs have continued to decline. The IRS has increased "account services"<sup>70</sup> in the TACs, while reducing tax preparation, tax-law questions, payment options, and transcript services. Taxpayers who need and prefer these services include low income and LEP taxpayers, seniors, and those with disabilities. Instead of providing services, the IRS refers these taxpayers to volunteers. Further, the IRS does not measure the quality of volunteer or paid preparer services compared to those provided by IRS employees, nor does the IRS consider or measure the downstream costs of noncompliance associated with a lack of service.

## IRS Comments

The IRS agrees with many of the issues raised in the National Taxpayer Advocate's report and we have worked with the Taxpayer Advocacy Panel (TAP) to assess potential improvements. The TAP survey results and the Taxpayer Assistance Blueprint (TAB) Phase II research validate that some segments of the taxpaying population will likely always need face-to-face service. The IRS is also committed to focusing the services offered at its TACs on the needs and preferences of its customers.

### Tac Data and Scope of Tax Law Assistance

The TAB data gathering efforts cited by the National Taxpayer Advocate that established the characteristics of each of the 401 TACs were not as reliable as the IRS would like. As a result, data collection efforts have been streamlined and new procedures were delivered to the TACs to ensure the accuracy of this data. This information will be used in the development of research models that, along with sound business judgments, will determine the future direction of IRS face-to-face services. At this point, it is unknown whether this research will lead to an expansion or contraction of such services.

The IRS agrees it must meet the needs of taxpayers in different geographic locations. The IRS plans to use data gathered through Contact Recording<sup>71</sup> and Q-Matic<sup>72</sup> to assess and

<sup>70</sup> Account services are assisting a customer with account related inquiries including: math error notices, Integrated Data Retrieval System (IDRS) work; Automated Collection System (ACS) work; Notice CP 2000 inquiries; Individual Taxpayer Identification Number (ITIN) issues involving account or IDRS research; Earned Income Tax Credit (EITC) qualifying children certification inquiries; payments processed requiring IDRS research; issuing Form 809 (receipt for payment of taxes), and referring an in-scope or out-of-scope account related question to the appropriate source.

<sup>71</sup> Contact Recording captures the audio portion of the assistor/taxpayer interaction, synchronized with computer screen activity, for replay and quality review.

<sup>72</sup> Q-Matic is an automatic queuing system used to control the flow of taxpayers waiting for assistance.

determine local taxpayer issues. This ongoing effort will allow the IRS to react to emerging issues and will aid in the development of research on geographic population trends and other local taxpayer characteristics. Once these emerging issues and local taxpayer needs have been identified, appropriate training and guidance will be developed to meet those needs.

We must point out, however, that just a few years ago the IRS was criticized for the relatively low level of tax law accuracy provided by its TACs. To successfully address this concern, the IRS took aggressive action to increase employee training, to implement enhanced quality measures and employee accountability, and to control the scope of the issues addressed. The latter is intended to allow our training to concentrate on the kinds of issues most often encountered in the TAC environment, as well as to ensure consistency with TAC employees' grade levels and experience. In this regard, Schedule F farm income issues are currently out-of-scope because this is a very complex area of the tax law. For example, determining the tax consequences of farm income and expenses reported on Schedule F includes such things as accrual accounting, leases and rents, inventory valuation, employee expenses, pensions and profit sharing, depreciation, cooperative distributions, agricultural program payments, crop insurance payments, and other very sophisticated and specialized issues. In addition, such questions are raised by TAC customers relatively infrequently, even in North Dakota.

### **Reductions in Staffing and Hours of Operation**

The reduction in TAC staffing from FY 2004 to FY 2007 is partially due to reduced use of seasonal appointments. Demand for services in the TACs fluctuates dramatically from filing season to off peak weeks in the summer and fall. Previously, the IRS planned for a more stable year-round workforce that would be adequate for both the filing season and the account and compliance-related work available during the remainder of the year. However, the IRS recently made a business decision to re-engage a seasonal workforce to better meet filing season demand. For FY 2008, our hiring goal is over 400 employees, of which 289 are planned new hires for the filing season. In the current business model, TACs with the most customers are given a share of this increased staffing.

There are other factors that contributed to the decline in TAC staffing cited in the National Taxpayer Advocate's report. These include the fact that TAC employees were highly trained and skilled in compliance work. As a result, they were often selected for other, higher-graded positions within IRS causing difficulties in maintaining a stable workforce. In 2007, policies were changed to no longer require accounting knowledge for TAC positions. As a result, the IRS is expecting an increase in applications for TAC jobs, as well as an increase in our ability to retain these employees.

Regarding TAC business hours, the IRS considers 37 ½ hours full time. Standard operating hours are 8:30 a.m. to 4:30 p.m., which allows employees 30 minutes each morning to complete time reports, training, or other required administrative duties before opening. TAC

offices open less than 35 hours per week generally employ only one or two persons. These and other small TACs with staffing of four employees or less must still allow their employees to have lunch and breaks as required by negotiated labor management agreements. In addition, there are times when operating hours are affected by employee retirements and selections for other jobs, illnesses and other unexpected absences, and scheduled vacations. Of the 401 TACs, 225 (56 percent) are small with four employees or less.

### Return Preparation and Other Services

The IRS agrees that requiring taxpayers to visit a TAC twice to have their returns prepared is a burden. For the 2008 filing season, new policy guidance has been issued that emphasizes TACs' ability to provide return preparation services for taxpayers that qualify without a prior appointment if trained employees are available and taxpayers have the necessary documents. Unfortunately, when customer demand exceeds a TAC's capability to provide this service, there is no alternative to scheduling an appointment. However, we are engaging the TAP during 2008 to help us develop an improved appointment process.

There are currently 401 TACs geographically dispersed across the United States. It is not possible for all the taxpayers in need of tax return preparation assistance to visit one of these IRS offices even if they had unlimited staffing or the number of sites was expanded. As a result, the IRS believes it is imperative that we continue to promote and expand other, more readily available, free return preparation options including Free-File, VITA, and Tax Counseling for the Elderly (TCE). Last year, IRS-sponsored VITA and TCE programs provided 77,000 volunteers in over 12,000 sites and prepared over 2.6 million returns for elderly, low income, and other hard-to-reach taxpayer groups like the disabled, Native Americans, and non-English speaking. Together with our volunteer partners, the IRS is also taking aggressive steps to improve volunteer return accuracy. Significant improvements were achieved last year and we expect even better results during 2008.

The IRS acknowledges that a full range of services are not offered in every TAC. Multiple factors influence specific TAC service delivery, including the number, training, and experience of the employees at each location. As previously noted, during FY 2008 we will be deploying additional staff that will enable us to revisit the range of services offered at each of our offices.

Additional steps to expand services include use of automated tools, such as facilitated self-assistance. This project was renamed to Facilitated Self Assist Research Project (FSRP) to reflect the testing of various applications. FSRP is supported by Wage & Investment Research, which is gathering and analyzing data to determine if this approach is a feasible and effective process, and whether the model should be implemented as part of the IRS's service offering in some or all of the TACs.

The services available through FSRP include those available on IRS.gov, such as Free File, filing or refund status, answers to tax law questions, forms and publications, the withhold-

ing calculator, Alternative Minimum Tax (AMT) and Earned Income Tax Credit (EITC) eligibility, and online EIN (Employer Identification Number). FSRP offers potential benefits for both the IRS and the taxpayer, including:

- Combination of assisted and self-assistance services may allow TACs to serve more taxpayers without additional resources;
- The self-assistance option may allow taxpayers to receive faster service now and in the future;
- Fewer taxpayers in line for assisted support may result in less wait time for taxpayers requiring assisted service and may increase TACs capacity to serve additional customers;
- FSRP provides willing customers the opportunity to change service delivery channels; and
- Individual Taxpayer Advisory Specialists (ITAS) will be able to assist more taxpayers with more complex issues.

### Cash Payments

The IRS believes payment acceptance encourages compliance. As a result, most TACs accept payments. We believe the incident cited by the National Taxpayer Advocate involving non-acceptance of a \$2 million payment is an isolated anomaly. Only 22 of the 401 TACs do not accept cash, and that is strictly due to staffing limitations. These very small offices are not required to do so because it requires an employee to be absent from the TAC while they convert such payments to bank drafts or money orders. The handling of cash is a sensitive matter and these procedures are required for internal control purposes. However, the IRS is currently seeking alternatives to the problems associated with cash conversion. As noted by the National Taxpayer Advocate, the IRS is testing a Self Service Cash Conversion kiosk at two TACs during 2008 to determine its potential for addressing this issue.

### Transcripts

The IRS is revisiting its policy regarding the availability of transcripts at the TACs. As noted by the National Taxpayer Advocate, previously taxpayers could walk into a TAC and request transcripts. That policy was changed when TACs began receiving bulk requests from return preparers and banking institutions that caused backlogs and delays in serving these requests and accommodating other customers. The IRS plans to encourage preparers and banking institutions to continue to use other available venues for these services but we are reconsidering the current limitations on servicing individual taxpayer transcript requests.

### Conclusion

In summary, consistent with the congressionally mandated Taxpayer Assistance Blueprint, the IRS is conducting research to determine the future scope of its face-to-face services. In

the near term, we are assessing the divergent needs of taxpayers in different geographic locations, we are increasing TAC staffing, and we are engaging the TAP in development of enhanced return preparation appointment procedures. We are also assessing opportunities to expand the services offered in our smaller TACs, researching the feasibility of facilitated self-assistance tools, and testing use of Self Service Cash Conversion kiosks. We are also improving the quality of volunteer services and reconsidering our TAC transcript policy. In brief, we are addressing each of the areas raised by the National Taxpayer Advocate in her report and we look forward to working with her as we continue to tailor and improve the services provided for our walk-in customers.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate recognizes the IRS's intention to improve taxpayer service in the Taxpayer Assistance Centers (TACs). We know this is a continuing process, and agree that establishing a valid research component and identifying the correct targeted population is critical to providing effective taxpayer service in the TACs.

### *Transcripts*

The National Taxpayer Advocate commends the IRS for the latest change of its transcript policy at the TACs and believes this action will improve customer and employee satisfaction. The new change to the IRM<sup>73</sup> will allow any taxpayer to approach and receive a copy of his or her account transcript (up to the last three years) regardless of urgency or reason. This is a significant improvement in service for taxpayers who visit the TACs. Accordingly, we expect to see a reduction in TAS cases relating to transcripts, which increased by 109 percent since the IRS changed its policy in October 2003.<sup>74</sup>

### *TAC Data and Scope of Tax Law Assistance*

We have previously discussed the issues of a taxpaying population that will likely always need face-to-face service.<sup>75</sup> As taxpayers' needs and technology change, the role of face-to-face service may change as well. We do not agree with the IRS proposal to base developing research solely on data gathered about taxpayers through the Contact Recording and Q-Matic systems. Contact Recording is a system designed to manage recordings for the purpose of quality reviews which usually are conducted randomly. Obtaining a valid sample of data from this system would be extremely time-consuming. The Q-Matic system will only capture information about a taxpayer service if the TAC provides the service. For instance, if a TAC identifies a service as out-of-scope and refuses to provide it, Q-Matic does not capture the service the taxpayer needed. The IRS should record data from taxpayers

<sup>73</sup> IRM, 21.3.4.14.4 (Dec. 19, 2007).

<sup>74</sup> Business Performance Management System, TAS, Case Receipts – Core Issue by Criteria Code; Issue Code 150 – Copies of Returns, Transcripts, Reports, FOIA. TAS cases increased from 2,894 in FY 2003 to 6,056 in FY 2007.

<sup>75</sup> IRS, Russell Research, *2007 Taxpayer Segmentation Study* 33 (Apr. 9, 2007).

that identifies the needs and preferences of those who are not aware of the services provided by the TACs, and from those who have been driven away during the last several years because of the changes in service. Specifically, the IRS should conduct a full-scale survey along the lines of the TAP survey discussed below, which includes responses from taxpayers who were in lines but not served by the TACs.

While the TAB research is commendable, the National Taxpayer Advocate believes that this effort is only the beginning. The IRS must increase research and testing to learn more about taxpayer needs, preferences, and motivations and mold taxpayer services to meet those needs, especially face-to-face services.<sup>76</sup>

The National Taxpayer Advocate is aware of historical criticism about tax law accuracy in the TACs. However, moving TACs away from tax law and preparation and toward account services will not solve taxpayer service problems or the administrative problems of training and accuracy rates. Employee accountability, training, office staffing, location, and administration are all leadership and management issues. Although the IRS may attempt to simplify problems by reducing services, this approach does not resolve quality issues, but does result in unmet taxpayer preferences and needs. Many taxpayers are already finding it more and more difficult to have their returns prepared and tax law questions answered face-to-face by TAC employees.

It is disturbing to read the IRS's explanation for not providing answers to certain tax law and procedure questions, such as those involving Schedule F, based on the rationale that the issues are too complex. If the nation's tax administrator cannot answer the questions, how can it expect taxpayers to file accurate returns? While it is true that tax law and procedure questions can be complex, the IRS cannot use this complexity as a rationale to deprive taxpayers of needed answers. Part of the solution is enhanced training for TAC personnel. For example, many self-employed or small business taxpayers do not know how to prepare or file a Schedule C, but could at one time obtain assistance at TACs from SB/SE employees. We believe larger TACs should again provide these services. The IRS's response also calls into question the policy decision to hire seasonal employees at the TACs. How will these employees develop the expertise to handle these matters? In light of the IRS's hiring policy, the inability of TAC employees to handle complex questions becomes a self-fulfilling proposition.

Based on contact with taxpayers, the National Taxpayer Advocate believes certain geographic locations need face-to-face services that address these types of issues, as walk-in sites did in the past. Taxpayer contacts with TAS employees working taxpayer issues also support this need. The position description of the Tax Resolution Representatives (TRRs) in the TACs is the same as Account Management TRRs (with some grade exceptions). In contrast to the performance by TAC TRRs, Accounts Management TRRs consistently

<sup>76</sup> See Most Serious Problem, *Taxpayer Service and Behavioral Research*, *supra*.



address tax law questions with increased accuracy. We believe improved staffing, training, and expertise, as well as high quality results in responding to taxpayer questions by TAC employees, are all achievable.

### *Reductions in Staffing and Hours of Operation*

Understandably, the decrease in staffing in 2007 in the TACs was caused by the reduced use of seasonal appointments. It is also understandable that increases in staffing create added problems regarding training and expertise. However, other IRS business units effectively train and maintain effective workforces. We applaud the IRS for its plans to boost TAC staffing, but we have two concerns. First, increased *seasonal* staffing will only increase training, leave, and attrition issues. Also, adding employees to TACs with high customer traffic before researching how best to use the new staffing may be a quick fix for the IRS, but will not increase taxpayer service. The National Taxpayer Advocate is confident that exploring alternative staffing choices such as hiring more permanent TAC employees will increase the likelihood of meeting more taxpayer's needs.<sup>77</sup> If there is no real choice but to hire seasonal TRR's, the IRS may want to explore outside tax preparation services to improve training methods and staffing procedures.

What is most striking in the IRS response about hours and staffing is the lack of commitment on the part of IRS management to the importance of TACs. If management viewed the TACs as an important means of communicating with taxpayers and assisting them, the IRS would make sure employees staggered their lunch periods or training periods; arranged for employees from other functions to serve on details to cover retirements, vacations, illness, etc; and planned *strategically* for these events.

TAS has some three-person offices that face the same challenges as the TACs in maintaining office coverage. Certainly there are times when despite our best efforts, we are unable to provide 100 percent coverage in these offices. Unlike the IRS and TACs, however, TAS views these instances as failures – because we are letting taxpayers down – and strives to do better. The IRS does not evidence a commitment to improving coverage.

### *Return Preparation and Other Services*

In the 2008 appropriations bill for Treasury and the IRS, Congress significantly *increased* funding for taxpayer service and intended some of those funds for the IRS to do more for tax preparation. In fact, the House bill states:

Of the increase above the budget request, \$31,200,000 is directed to be targeted toward the following activities: (1) increasing IRS outreach and education activities, for individuals, businesses, and tax-exempt entities, above the levels assumed in the fiscal year 2008 budget request, and (2) increasing the number of tax returns prepared at the IRS Taxpayer Assistance Centers. The Department is directed to include, in its fiscal

<sup>77</sup> The IRS may want to consider establishing dual position descriptions with Accounts Management (AM) or working AM cases available on the AM Correspondence Information System (CIS).

year 2008 operating plan, a specific plan for increasing these activities above the levels assumed in the budget request.<sup>78</sup>

We believe that this final appropriation bill language supports the concept that VITA is not a substitute for IRS tax preparation.<sup>79</sup>

For a taxpayer to visit a TAC to schedule an appointment for return preparation requires the use of IRS staff hours. This output of staff hours for scheduling, if eliminated, will free up more hours for tax preparation. Additionally, leaving a certain number of open slots for walk-in taxpayers requiring tax preparation may help improve the process. Another way to reduce taxpayer burden is to modify the requirement that a taxpayer present original Social Security cards for themselves and dependents to obtain tax preparation.<sup>80</sup> Many of us would not be able to produce an original card if required to do so. A passport or driver's license should be an acceptable substitute. Engaging stakeholders by consulting Low Income Taxpayer Clinics and TAP members to help develop an improved appointment procedure and process would be a noteworthy endeavor, which will help the IRS obtain a more objective perspective on taxpayers' needs.

The National Taxpayer Advocate agrees with automating some IRS services for taxpayers who prefer e-services. However, the most recent TAP report indicates that almost 60 percent of respondents that visited a TAC had Internet access at home, demonstrating that even taxpayers with the Internet often prefer personal service.<sup>81</sup> Therefore, substituting e-services for face-to-face IRS service is troublesome, as previously detailed in this report.

The TAP report also shows that about one third of respondents reported needing a service that was not available at the TACs they visited. Ranked in order of need, they are:

1. Tax preparation help;
2. Forms or publications; and
3. A copy of a prior year return.<sup>82</sup>

<sup>78</sup> United States Congress, Committee on Appropriations, *FY 2008 Omnibus Explanatory Statement, Division D-Financial Services and General Government Appropriations Act, 2008* 7 (Dec. 19, 2007).

<sup>79</sup> In House Report 110-207, it was noted:

The Committee believes these funding increases are especially necessary because the IRS has reduced these activities significantly in recent years. These services are important in helping individuals and businesses to understand their tax obligations and to file correct tax returns. While the IRS notes that an increasing amount of these services are being provided as a result of various volunteer efforts, including Volunteer Income Tax Assistance (VITA) sites, Tax Counseling for the Elderly (TCE) sites, and others, the Committee believes that this should not serve as a justification to reduce IRS services in these areas. Volunteer services should supplement, not replace, IRS services. The Committee notes that the IRS Oversight Board and the IRS National Taxpayer Advocate have both stressed the continued importance of IRS services related to outreach and education, and the IRS National Taxpayer Advocate has additionally stressed the importance of maintaining IRS assistance in preparing tax returns.

House Report 110-207-Financial Services and General Government Appropriations Bill, 2008, *Continuing Importance of IRS Taxpayer Services*, Taxpayer Services (June 2007).

<sup>80</sup> IRM 21.3.4.10 (Nov. 27, 2007).

<sup>81</sup> Taxpayer Advocacy Panel Taxpayer Assistance Centers, *Customer Service From Both Sides of the Counter*, 21 (Nov. 30, 2007).

<sup>82</sup> *Id.* at 21.

### *Cash Payments*

The National Taxpayer Advocate encourages the IRS to continue exploring alternatives to the problems associated with cash conversion. A solution would benefit not only taxpayer compliance but Field Assistance employee satisfaction.<sup>83</sup> From reviewing complaints TAS has received from taxpayers, it appears that each local TAC manager has great latitude in applying Field Assistance policy. This latitude may at times negatively impact taxpayers, as when the IRS rejected the \$2 million payment.

### *Learning from Others*

The National Taxpayer Advocate is encouraged by the actions the IRS is taking and has committed to take in the future with respect to the Taxpayer Assistance Blueprint. The role of the IRS in taxpayer service is constantly evolving and the IRS's leadership is meeting this challenge. We remind the IRS that the most critical step the IRS can take is to view taxpayer service from the taxpayer perspective. We are hopeful that the IRS will consider divergent opinions from taxpayers, stakeholders, and operating division employees. The IRS has already begun this engagement by working with the TAP as part of the TAB.<sup>84</sup> The IRS can continue these efforts by consulting with the LITCs, which represent low income and English as a second language (ESL) taxpayers. The clinics have become proficient at understanding the problems these taxpayers face and developing innovative ways of dealing with these problems. Another resource is the Local Taxpayer Advocates who receive many of the clients not serviced at the local TACs.

## Recommendations

The National Taxpayer Advocate recognizes the steps the IRS has taken thus far, and recommends the IRS make the following changes to further improve service at Taxpayer Assistance Centers:

- Conduct a full-scale survey along the lines of the TAP survey discussed previously which includes responses from taxpayers who were in line for, but ultimately were not served by TAC personnel.
- Provide a specific vehicle or process for obtaining stakeholder advice and best practices. Involve TAC employees who will be serving taxpayers in this process.
- Conduct a full-scale survey to research population segments (low income, elderly, disabled, and limited English taxpayers) across the United States to determine the particular face-to-face out-of-scope service taxpayers need by geographical location, such as farmers, fishermen, foresters and small business self-employed. The IRS

<sup>83</sup> TAC TRRs were asked which services were hindered most by current policies. They responded: Answering tax law questions, 36 percent, **Accepting cash payments 34 percent**, and Transcript Delivery System 23 percent. Taxpayer Advocacy Panel Taxpayer Assistance Centers, *Customer Service From Both Sides of the Counter*, 25 (Nov. 30, 2007).

<sup>84</sup> Taxpayer Advocacy Panel Taxpayer Assistance Centers, *Customer Service From Both Sides of the Counter*, Nov. 30, 2007.

should not limit this research to taxpayers approaching the TACs. Include an analysis of the relationship between taxpayer services and voluntary compliance. As a result of the study change out-of-scope issues to in-scope and train employees accordingly.

- Change the tax preparation appointment process at TACs to include the option of scheduling appointments by phone or other user-friendly choices.
- Provide same-day service to taxpayers traveling to a TAC and do not turn them away or refer them elsewhere.
- Make it a priority of answering calls on published TAC telephone numbers. The IRS should also market telephone numbers to the community by methods such as forms and publications, television, and radio as well as the IRS website.
- Provide small business representatives at each larger TAC location.
- Accept *all* payments presented to the IRS, understanding that cash payments must be converted to money orders.
- Ensure that all monies saved from shifting taxpayers to electronic services should be funneled directly into providing face-to-face services at TACs.

MSP  
#12**Outreach and Education on Disability Issues  
for Small Business/Self-Employed Taxpayers****Responsible Official**

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division

**Definition of Problem**

People with disabilities have always struggled to find employment, largely because of the numerous barriers facing this population. Some may seek to overcome these barriers through self-employment or by running their own businesses. The IRS has conducted little outreach or education for small business owners and self-employed individuals who have a disability. Outreach to these taxpayers is increasingly important because some professionals believe that being self-employed or owning small businesses is an increasing trend in the disability community.<sup>1</sup> One of the most significant obstacles facing disabled individuals in starting their own businesses is the inaccessibility of business materials.<sup>2</sup> Thus, the IRS should ensure that tax administration is not a barrier to disabled individuals entering business, but is a resource for these entrepreneurs.

The IRS also could improve its outreach and education on the tax credits and deductions available to small business owners who employ people with disabilities and design accessible workplaces. Congress created these deductions and credits to relieve some of the financial burden of complying with the Americans with Disabilities Act and to encourage the employment of persons with a disability. Many of these important credits and deductions are underutilized, in part because of the lack of outreach and education.<sup>3</sup>

**Analysis of Problem****Background**

Over the past few decades, Congress has passed numerous pieces of legislation designed to protect the rights of people with disabilities<sup>4</sup> and help these individuals to enter the work-

<sup>1</sup> Department of Labor, *Business Ownership - Cornerstone of the American Dream*, at <http://www.dol.gov/odep/pubs/business/business.htm>.

<sup>2</sup> *Id.*

<sup>3</sup> General Accounting Office, GAO 03-39 *Business Tax Incentives* (Dec. 2002) at [http://www.cdc.gov/nchs/about/major/nhis\\_dis/nhis\\_dis.htm#data%20highlights](http://www.cdc.gov/nchs/about/major/nhis_dis/nhis_dis.htm#data%20highlights).

<sup>4</sup> Nondiscrimination under Federal Grants and Programs, 29 U.S.C. § 794. This act prohibits federal agencies and programs receiving federal funding from discriminating against people with a disability in federal employment and in the employment practices of federal contractors. Findings and Purpose, 42 U.S.C. §§ 12101 et seq (1990); Americans with Disabilities Act of 1990, Pub. L. No. 101-336, 104 Stat. 327 (Jul. 26, 1990). This act prohibits the following entities from discriminating on the basis of disability: state and local governments, public accommodations, commercial facilities, transportation, and telecommunications. It also applies to Congress.

force and become economically stable.<sup>5</sup> Although these were landmark laws in the disability arena, and have helped bring about significant strides in equality, the rate of employment for people with a disability is still much lower than for others. Research conducted by the IRS's Wage and Investment (W&I) division showed 75 percent of adults without a disability were employed, compared to only 51 percent of people with a disability.<sup>6</sup> This disparity translates into a significant income gap and demonstrates the challenge of closing the employment gap between people with and without disabilities.

### **Improving Accessibility and Education to Taxpayers with a Disability who Own a Small Business or are Self-Employed**

Entrepreneurship and self-employment are increasingly viewed as a useful vehicle for taxpayers with a disability to secure a foothold in America's labor market. In fact, taxpayers who have disabilities are becoming self-employed or small business owners at a higher rate than those without a disability, and it seems this rate is increasing.<sup>7</sup> Some lending institutions are attempting to target this group by developing accessible websites so a person with a disability can apply for a small business loan online, or even by creating special loans for entrepreneurs with a disability.<sup>8</sup> With this new trend taking hold, it is vital that the IRS conduct targeted outreach and provide accessible information to this group of self-employed and small business owner taxpayers.

### ***Communication and Outreach to Taxpayers with a Disability***

Currently, the IRS conducts little outreach to taxpayers with a disability who are self-employed or own a small business. One of the most significant challenges facing these taxpayers is obtaining accessible information on self-employment or owning businesses.<sup>9</sup> The IRS's Small Business/Self-Employed (SB/SE) division should design a multi-faceted outreach and education campaign, which would include using technology, in-person outreach sessions, and partnering with disability organizations.

It is essential that SB/SE develop a variety of ways to communicate with taxpayers with disabilities, since these individuals often use different skills to communicate effectively. For instance, some taxpayers with a disability may require a translator, materials in an

<sup>5</sup> Procedures and Debate, 101st Congress, 2nd Sess., 136 Cong. Rec H2421-02, Americans with Disabilities Act of 1990 (May 17, 1990).

<sup>6</sup> IRS, Wage and Investment Research, *Characteristics of Disabled Taxpayers Age 18-59: Study of Filing Patterns and Preferences of Receiving Tax Information and Services* 14 (May 4, 2007).

<sup>7</sup> Department of Labor, *Business Ownership - Cornerstone of the American Dream*, at <http://www.dol.gov/odep/pubs/business/business.htm>. Peter David Blanck, Leonard A. Sandler, James L. Schmeling, Helen A. Scharz, *The Emerging Workforce of Entrepreneurs with Disabilities: Preliminary Study of Entrepreneurship in Iowa* 85 Iowa, L. Rev. 1583 (Aug. 2000). This article includes the following statistics indicating an increase in the number of people with a disability who have become entrepreneurs or small business owners since the passage of the ADA. For example, workers with disabilities are nearly twice as likely to be self-employed as workers who are not disabled, and the 1990 national census reported 12 percent of people with disabilities had self-employment and small business experience, as compared with eight percent of people without disabilities. Moreover, in 1994, more than 14 percent of individuals with disabilities owned or worked for a small business, whereas eight percent of individuals without disabilities did so.

<sup>8</sup> Peter David Blanck, Leonard A. Sandler, James L. Schmeling, Helen A. Scharz, *The Emerging Workforce of Entrepreneurs with Disabilities: Preliminary Study of Entrepreneurship in Iowa*, 85 Iowa, L. Rev. 1583 (Aug. 2000).

<sup>9</sup> Department of Labor, *Business Ownership - Cornerstone of the American Dream*, at <http://www.dol.gov/odep/pubs/business/business.htm>.

alternative format, or materials that can be accessed with assistive technology. The type of accommodation needed to communicate effectively will vary according to the taxpayer's disability.

### Technology

Section 508 of the Rehabilitation Act requires the IRS and other federal agencies to make their websites accessible to people with a disability.<sup>10</sup> The IRS should not just strive to meet this minimum requirement, but should work to make its pages as user-friendly as possible for taxpayers with a disability. In recent years, SB/SE has been placing more outreach materials on its web page (taxpayers can also order these products over the Internet or by telephone).<sup>11</sup> The division's Internet outreach initiatives include:

- The Small Business and Self-Employment online classroom;
- The Small Business Research Guide; and
- The virtual Small Business Forum.

Although SB/SE has developed impressive outreach and education products, they are useless to a taxpayer with a disability if they are not accessible. Therefore, the IRS should make these resources more accommodating to disabled taxpayers.<sup>12</sup> For example, the IRS could allow the taxpayer to manipulate the website to meet his or her individual accessibility needs, such as fonts, color, and a speech option. Also, for the audio portion of the small business classroom, SB/SE should provide a streaming translation in American Sign Language (ASL). Although the resource is not completely unusable to the deaf and hard-of-hearing because SB/SE provides a transcript of the audio course, it is more difficult for taxpayers who are deaf or hard-of-hearing to use it because it is not in their primary language.<sup>13</sup> A streaming video translation of the lessons would allow the deaf or hard-of-hearing taxpayer to fully utilize the small business classroom. Making these products more accessible will allow taxpayers with disabilities to have easy access to information that could help them gain economic stability.

<sup>10</sup> Findings and Purpose, 29 U.S.C. 794d, as amended by the Workforce Investment Act of 1998 (Pub. L. No. 105-220, (Aug. 7, 1998), provides (a) REQUIREMENTS FOR FEDERAL DEPARTMENTS AND AGENCIES.-- (1) ACCESSIBILITY.-- (A) DEVELOPMENT, PROCUREMENT, MAINTENANCE, OR USE OF ELECTRONIC AND INFORMATION TECHNOLOGY.--When developing, procuring, maintaining, or using electronic and information technology, each Federal department or agency, including the United States Postal Service, shall ensure, unless an undue burden would be imposed on the department or agency, that the electronic and information technology allows, regardless of the type of medium of the technology-- (i) individuals with disabilities who are Federal employees to have access to and use of information and data that is comparable to the access to and use of the information and data by Federal employees who are not individuals with disabilities; and (ii) individuals with disabilities who are members of the public seeking information or services from a Federal department or agency to have access to and use of information and data that is comparable to the access to and use of the information and data by such members of the public who are not individuals with disabilities.

<sup>11</sup> National Taxpayer Advocate 2006 Annual Report to Congress 179-180.

<sup>12</sup> National Institutes of Health, *Elderly* at <http://nihseniorhealth.gov>. This is a good example of a website that provides people with disabilities a variety of options to meet their individual needs and makes the site accessible for them.

<sup>13</sup> Hoffmeister, R. J., De Villiers, P. A., Engen, E., & Topol, D. (1997). *English Reading Achievement and ASL Skills in Deaf Students*. Proceedings of the Annual Boston University Conference on Language Development, 21(1), 307-318; Nover, S. M., Christensen, K. M., & Cheng, L. R. L. (1998). *Development of ASL and English Competence for Learners Who Are Deaf*. *Topics in Language Disorders*, 18(4), 61-72; and Prinz, P. M. & Strong, M. (1998). *ASL Proficiency and English Literacy within a Bilingual Deaf Education Model of Instruction*. *Topics in Language Disorders*, 18(4), 47-60. Many advocates for the deaf and hard-of-hearing have written about why ASL is considered a formal language, and for many deaf and hard-of-hearing people, their primary language.



### Live Outreach Sessions

Although developing and creating accessible electronic products is an extremely important step in improving outreach to taxpayers with disabilities, it is not the only answer. As stated previously, the IRS needs a multi-faceted campaign to meet the diverse needs of this underserved group. One part of the campaign should be providing live outreach sessions to taxpayers with a disability. SB/SE provides an average of 45 live outreach sessions monthly, but these sessions are limited to 33 states and the District of Columbia.<sup>14</sup> Moreover, SB/SE conducts no sessions that target taxpayers with disabilities. Live outreach is especially important to this population because these taxpayers may not have the often expensive software that allows them to use computers and access the Internet.<sup>15</sup> In fact, only 59 percent of taxpayers with a disability use computers at home, compared to 76 percent of taxpayers without a disability.<sup>16</sup>

Further, SB/SE should ensure that, like the products on IRS.gov, these live sessions are accessible to all taxpayers. SB/SE considers these sessions accessible because SB/SE instructs visually impaired or blind taxpayers to bring laptops to the session, and gives them CDs that includes the session's PowerPoint so they can manipulate the presentation to make it accommodating. It seems questionable whether these sessions are accommodating. Providing a live session that really meets the taxpayers' needs may be the most effective way to reach those with disabilities and should not be difficult since the IRS has participated since 2004 in a disability initiative with other federal government and outside organizations.<sup>17</sup>

### Partnering With The IRS's Disability Initiative

The Stakeholder Partnerships, Education and Communication (SPEC) organization in W&I has set an example for SB/SE by developing a disability toolkit. This resource is designed to educate SPEC's community-based partners, such as Goodwill Industries, which have direct contact with the disabled community and provide guidance on how to establish work-groups to assist disabled taxpayers with tax preparation, financial literacy, and asset building. This toolkit is available to the public and is being utilized by SPEC and

<sup>14</sup> IRS, SB/SE response to TAS research request (Oct. 26, 2007). The SB/SE division of the IRS recently canvassed its Stakeholder Liaison Area Managers for the number of workshops conducted by the Small Business Administration, even though it generally does not track this information, through SCORE (an organization that focuses on small business counseling) program and Small Business Development Centers (SBDCs). These are the two primary organizations that conduct the workshops on behalf of SB/SE. The Stakeholder Liaison Area Managers determined, on average, 45 workshops are conducted monthly in 33 states plus the District of Columbia. It is alarming that there are numerous states where no workshops are being conducted for taxpayers.

<sup>15</sup> Freedom Scientific, at <http://www.freedomscientific.com>. Screen reading programs and screen magnification programs for the blind and visually impaired can be expensive to purchase. This is an especially important point since the median adjusted gross income (AGI) for taxpayers with a disability is \$19,100, compared to \$33,800 for taxpayers without a disability. IRS, W&I Research, *Characteristics of Disabled Taxpayers Age 18-59: Study of Filing Patterns and Preferences of Receiving Tax Information and Services 20* (May 4, 2007).

<sup>16</sup> IRS, Wage and Investment Research, *Characteristics of Disabled Taxpayers Age 18-59: Study of Filing Patterns and Preferences of Receiving Tax Information and Services 4, 19* (May 4, 2007). This study further found that only 17 percent of taxpayers with a disability were inclined to prefer IRS.gov, compared to 33 percent of taxpayers without a disability.

<sup>17</sup> The Real Economic Impact Tour is an initiative where government and private organizations, including TAS and SPEC, have partnered to conduct outreach in 54 select cities in an effort to educate taxpayers with a disability on how to use the tax code to reach economic stability, and a variety of other issues. Real Economic Impact Tour, *Building Economic Futures for Americans with Disabilities*, <http://www.reitour.org>.

its partners. SPEC has also created a page on its internal (IRS intranet) website devoted entirely to disability issues, with information on outreach and education.<sup>18</sup> Further, SPEC, TAS, and other government entities have partnered with outside organizations such as the National Disability Institute (NDI) in a nationwide initiative known as the Real Economic Impact Tour to educate taxpayers with disabilities on tax deductions and credits that may help reduce their tax due or obtain refunds.<sup>19</sup> SB/SE should join this initiative and use it as a platform for educating taxpayers with a disability about being self-employed or a small business owner.

### Disability Tax Incentives for Small Business and Self-Employed Taxpayers

When Congress passed the ADA, it also approved a package of tax deductions and credits designed to help small business owners ease the financial burden of the ADA and encourage businesses to make their establishments more accessible. These incentives are underused, however, and SB/SE does very little to educate taxpayers about them.<sup>20</sup>

#### Tax Deductions and Credits

The two major incentives Congress created for the small business owner are:

- *Disability Access Credit (DAC)*: Small businesses can use this tax credit for expenses incurred by complying with the ADA, which may include architectural adaptations, equipment acquisitions, and services such as sign language interpreters.<sup>21</sup> Taxpayers can claim up to 50 percent of the first \$10,000 of eligible expenses that exceed \$250.
- *Deduction for Removing Barriers for the Disabled and Elderly*: This deduction allows a business of any size to deduct expenses of up to \$15,000 per year associated with the removal of architectural or transportation barriers in connection with a trade or business to comply with applicable accessibility standards.<sup>22</sup>

These incentives can be extremely useful to small business owners but they are complicated and difficult to understand. It is not always clear when a small business owner is eligible for the DAC. The credit applies to businesses that have 30 or fewer full-time employees or have less than or equal to one million dollars in gross yearly proceeds.<sup>23</sup> The business is allowed a credit of half of the cost of the access expenditure for the first \$10,000 of eligible expenses that exceed \$250; therefore, the maximum allowable credit would be \$5,000.<sup>24</sup>

<sup>18</sup> IRS, *Wage and Investment Insider*, [http://win.web.irs.gov/spec/SPEC\\_disability.htm](http://win.web.irs.gov/spec/SPEC_disability.htm).

<sup>19</sup> Real Economic Impact Tour, *Building Economic Futures for Americans with Disabilities*, <http://www.reitour.org>.

<sup>20</sup> General Accounting Office, GAO 03-39, *Business Tax Incentives* (Dec. 2002). Although the GAO report does not directly connect the low numbers of eligible businesses who claim the Disability Access Credit, Deduction for Removing Barriers for the Disabled and Elderly, and Work Opportunity Credit to a lack of outreach and education, it does strongly recommend that federal agencies, including the IRS, increase their outreach and education efforts.

<sup>21</sup> IRC § 44.

<sup>22</sup> IRC § 190.

<sup>23</sup> IRC § 44.

<sup>24</sup> *Id.*

Only a small proportion of corporations and individuals with affiliations with business claim the credit, possibly because of unclear IRS guidelines.<sup>25</sup> There is some question about whether businesses with fewer than 15 employees can take this credit because its intent is to alleviate the financial burden of complying with the ADA,<sup>26</sup> and the ADA only covers businesses with 15 or more employees.<sup>27</sup> Unless the IRS clarifies its policy, taxpayers may be discouraged from taking the credit for fear of claiming it incorrectly.<sup>28</sup>

The lack of IRS guidance about what types of equipment and devices are eligible for the DAC also makes it difficult for businesses to determine whether they can take the credit. The IRS has provided information on other types of expenditures that qualify for the credit, such as removing architectural barriers that prevent a business from being accessible, hiring interpreters, and providing qualified readers and taped text for blind and visually impaired employees. However, the IRS offers no such examples on what types of equipment and devices for the disabled would qualify. The IRS has put forth only the following: businesses must show that the devices were reasonable and necessary for the effective treatment of communication with people with disabilities.<sup>29</sup> The IRS's lack of guidance is contrary to a 2002 General Accounting Office (GAO, now the Government Accountability Office) report that recommends a broader application of these incentives.<sup>30</sup> While the lack of guidance could be viewed as the IRS being flexible and not imposing too many restrictions on the types of equipment and devices that qualify for the DAC, producing guidance with examples would help businesses determine if the equipment or devices would qualify for the credit. Without clear guidance, businesses are left to guess which types of equipment and devices qualify, and many businesses would likely err on the side of caution and not spend funds on equipment and devices for which they may or may not be able to claim a credit. Thus, clear parameters for businesses to follow would make the DAC more useful and promote accessible workplaces.

### *Outreach and Education on Disability Tax Incentives*

Despite the usefulness of these incentives, SB/SE has done very little to educate taxpayers about them. SB/SE's website contains only a brief discussion of these issues,<sup>31</sup> and does not

<sup>25</sup> IRS, Compliance Data Warehouse, For tax year 2005 only 3,762 taxpayers filed a Schedule C and claimed the disability access credit. This number seems especially low since there were 20,515,211 taxpayers who filed a Schedule C and had gross receipts less than or equal to \$1,000,000 and therefore would be eligible for the credit if the other criteria were met. This means less than one percent of taxpayers who file a schedule C and meet the gross receipts threshold claim the DAC. Although there could be a number of explanations for this low number, it seems reasonable for the IRS to conduct further research to identify these reasons and then take steps to address them. See also General Accounting Office, GAO 03-39, *Business Tax Incentives* (Dec. 2002).

<sup>26</sup> IRS, Form 8826, *Disability Access Credit* (2005); see also 136 Cong. Rec. E2679-02 (1990).

<sup>27</sup> 42 U.S.C.A § 12111(5)(A).

<sup>28</sup> General Accounting Office, GAO 03-39, *Business Tax Incentives* 25 (Dec. 2002): IRS guidelines do not clearly state whether a business that is not required by title I of the ADA to accommodate employees can use the credit for these expenditures.

<sup>29</sup> IRC § 44 and IRS, Form 8826, *Disability Access Credit* (2005).

<sup>30</sup> General Accounting Office, GAO 03-39, *Business Tax Incentives* 25, 27 (Dec. 2002).

<sup>31</sup> IRS, *Know the Rules Regarding Tax Incentives for Improving Accessibility for the Disabled*, at <http://www.irs.gov/businesses/small/article/0,,id=113382,00.html>.

provide any examples of what expenses would qualify for the credit and deduction.<sup>32</sup> This minimal outreach may be a factor in the low number of taxpayers who actually apply for these incentives.<sup>33</sup> The information that SB/SE does provide is difficult to locate, because it is scattered throughout IRS.gov. Therefore, as stated previously in the National Taxpayer Advocate's 2006 Annual Report to Congress, the IRS should develop a centralized website that would include information on tax deductions and credits for disabled taxpayers and how to request IRS materials in an alternative format.<sup>34</sup> Placing all this information in one location, with links to other appropriate sites, is more logical than scattering it throughout the IRS site. Moreover, finding this information can be difficult for all taxpayers, but may be even more difficult and frustrating for those with a disability. The IRS should take steps to reduce this frustration and make it easier for taxpayers with a disability to access vital tax information.

## Conclusion

The IRS plays an important role in increasing economic stability among taxpayers with a disability and SB/SE has an increasingly important role in helping these taxpayers gain a foothold in the U.S. labor market. Specifically, SB/SE should take a number of steps to reach this large and diverse group of taxpayers, such as designing accessible education resources, targeting live outreach sessions to the disability community, and better educating small business owners on deductions and credits available for making their establishment accessible or providing accommodations to taxpayers with a disability, are all important in promoting a strong economic future for the disability community. The National Taxpayer Advocate encourages SB/SE to follow the example of other organizations within the IRS and truly work to improve outreach to this segment of the U.S. population.

## IRS Comments

The IRS agrees on the importance of outreach and education to both disabled individuals engaging in small business ownership and to small business owners who hire disabled employees. We appreciate the National Taxpayer Advocate's continuing interest in this

<sup>32</sup> IRS, *Know the Rules Regarding Tax Incentives for Improving Accessibility for the Disabled*, at <http://www.irs.gov/businesses/small/article/0,,id=113382,00.html>.

<sup>33</sup> IRS, Compliance Data Warehouse, For tax year 2005 only 3,762 taxpayers filed a Schedule C and claimed the disability access credit. This number seems especially low since there were 20,515,211 taxpayers who filed a Schedule C and had gross receipts less than or equal to \$1,000,000 and therefore would be eligible for the credit if the other criteria were met. This means less than one percent of taxpayers who file a schedule C and meet the gross receipts threshold claim the DAC. General Accounting Office, GAO 03-39 *Business Tax Incentives* (Dec. 2002). Although the GAO report strongly recommended that federal agencies, including the IRS, increase outreach and education efforts to increase the low numbers of eligible businesses who claim the Disability Access Credit, Deduction for Removing Barriers for the Disabled and Elderly, and Work Opportunity Credit, the IRS has done little to address this recommendation. Academic disability researchers, businesses, disability groups, and other interested parties we interviewed proposed various options to increase the awareness and usage of the incentives, including (1) expanding and improving federal outreach through better coordination and clarification of incentive requirements; (2) increasing the maximum amount allowed to be claimed; and (3) expanding eligibility to cover more workers with disabilities, businesses, and types of accommodation.

<sup>34</sup> National Taxpayer Advocate 2006 Annual Report to Congress at 394; taxpayers can request from the IRS's Alternative Media Center (AMC) any form, publication, notice or bill in an alternative format, such as Braille or large print. IRS, *Alternative Media Center*, <http://www.irs.gov/help/page/0,,id=13148,00.html>.

area, and as committed to last year, SB/SE recently launched a multi-component outreach and education campaign, both nationally and locally, to provide information to the disabled small business community.

This strategy includes a partnership between SB/SE's Communications, Liaison and Disclosure (CLD) Stakeholder Liaison (SL), and W&I SPEC, as well as partnering with external stakeholders, such as the Department of Labor's Office of Disability Employment, the National Organization on Disability, the NDI, and others to provide distribution channels for sharing key messages and information. Our strategic partnership with SPEC includes participating with them to present disability educational messages as part of the Real Economic Impact Tour, which celebrates the accomplishments of the IRS's partnership with the NDI and brings awareness to various tax incentives offered to individuals with disabilities and businesses that employ persons with disabilities.

### **The Multi-Component Disability Outreach and Education Strategy**

The comprehensive disability outreach strategy's main objective is to educate the business community on the availability of tax incentives for hiring disabled workers.

The outreach strategy focuses on:

- ADA tax incentives;
- Business tax credits and deductions for employment of people with disabilities; and
- General resource information providing services to employers and employees through leveraged partnerships.

In addition to the information identified above, there are several components of the strategy that include:

- Key messages, forms and publications, presentation materials, fact sheets, Headliner, and talking points, with specific information relevant to the disabled business community.
- A drop-in article for publication in the IRS/SSA Reporter and the Department of Labor newsletter.
- Centralized information on the IRS website regarding the deductions and credits to which small businesses may be entitled.
- Links on external websites such as [www.business.gov](http://www.business.gov) and [www.disabilityinfo.gov](http://www.disabilityinfo.gov) for businesses and individuals searching for resource information on the Internet.
- Engagement with external partners, such as the Department of Labor's Office of Disability Employment, the National Organization on Disability, the NDI, and others to provide distribution channels for sharing key messages and information.
- Engagement with an internal partner, W&I SPEC, to combine messages regarding disability outreach for individual and business taxpayers.

The products and services provided in the Disabled Outreach Strategy were designed to educate businesses and taxpayers on the tax credits and incentives available to them. In addition, related tools are on CLD's Outreach Initiatives Database to ensure that IRS employees are aware of these key messages and for dissemination at all liaison events nationwide.

### **Educational Opportunities for Disabled Taxpayers**

The IRS utilizes a combination of leveraged and direct methods to deliver outreach to customer segments. The IRS experience and feedback from partners and customers indicates that taxpayers rely on trusted third parties and stakeholder groups (such as the National Organization on Disability and the NDI) to service their tax needs. Leveraging our outreach products and messages gives us greater reach and enables us to increase the number of outreach contacts 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.

Live outreach is primarily delivered through partnerships with interest groups representing persons with disabilities or those that employ the disabled. The outreach includes providing tax related information through fact sheets, forums, and other communication vehicles. Targeted and live outreach by the IRS includes the "Real Economic Impact Tour," a joint effort between W&I SPEC and SB/SE. In 2006, the "Real Economic Impact Tour," included 30 cities and for 2007, expanded to 54 cities. The IRS has also developed Publication 3966, Living and Working with Disabilities, which provides a summary of existing tax credits and benefits that may be available to qualifying taxpayers with disabilities, parents of children with disabilities, and businesses or other entities wishing to accommodate persons with disabilities. This publication directs the user to other publications that are available in alternative formats. To date, over one million copies of this publication have been distributed and the product is available on the IRS website, as well as many of the IRS's national partners' websites.

SB/SE CLD also leverages outreach through workshops, seminars and events geared toward the practitioner and small business industry groups serving the needs of the small business community, including business owners with disabilities. A key face-to-face educational opportunity specifically for the small business owner is the Small Business Leveraged Tax Workshop, which is taught through industry partners, such as the Small Business Administration, Small Business Development Centers and the Service Corps of Retired Executives (SCORE). These workshops are designed to provide education about tax topics, products and services that are important for everyone in the small business community.

The majority of IRS seminars are conducted at Small Business Development Centers on college campuses, in government offices or libraries that accommodate taxpayers with wheelchair accessibility and all PowerPoint presentations are section 508 compliant. We encourage small business owners with a disability to attend these workshops by including information to assist in their attendance in our marketing materials. A statement on the



promotional flyer states, "Special arrangements for the disabled will be made, if requested in advance. The program is provided on a non-discriminatory basis." Information about past and future events is accessible on the IRS website at <http://www.irs.gov/businesses/small/article/0,,id=127801,00.html>.

CLD Stakeholder Liaison also provides educational opportunities from the convenience of the participants' home or office, including Tax Talk Today – a web-based program – and national and local phone forums. Tax Talk Today, presented eight times a year, provides significant tax information in a panel format comprised of IRS subject matter experts and practitioners. These programs may be viewed from any computer. The national and local phone forums present topics focused on the needs of stakeholders, such as Navigating the IRS, Forms 1099, Identity Theft, Payroll & Foreign Workers and Electronic IRS. Registration for these forums is found on [irs.gov](http://irs.gov) and participants can call in from any location. We continue to explore ways to make these forums more available and accessible to persons with disabilities.

Another available course accessible to taxpayers with disabilities is the Small Business Tax Workshop, presented through an interactive DVD or as a streaming video online at <http://www.irs.gov/smallbiz>. This course contains all the materials used in the classroom workshops taught by IRS partner organizations. We will consider adding sign language interpretation to this DVD as budgetary and employee resources allow, and in the interim, transcripts of the workshop text are available at [irs.gov](http://irs.gov).

With respect to the concern that additional guidance is needed to better educate taxpayers on the disability tax incentives, this is a component of the Disability Outreach Initiative. The IRS plans to assess current guidelines concerning disability tax incentives for business taxpayers. The enhanced guidelines will include examples and outline what does or does not qualify. These enhancements will be incorporated into ongoing outreach, updated in publications, and on [www.irs.gov](http://www.irs.gov), and shared with other operating divisions for their use.

### **Technology and Taxpayer Assistance**

The IRS has engineered a considerable direct delivery channel using the Internet, and some of the available resources are discussed above. There is a vast amount of information and resources available on the IRS website for all taxpayers starting their own business, which is also valuable for disabled individuals starting a business: <http://www.irs.gov/businesses/small/article/0,,id=99336,00.html>. There is also information on the IRS website regarding forms and publications related to disabilities: <http://www.irs.gov/individuals/article/0,,id=168606,00.html>.

SB/SE's Web Services team makes every effort to comply with § 508 of the Rehabilitation Act when posting information to [irs.gov](http://irs.gov) and these links are accessible for the disabled. There is an accessibility link located at the bottom of each page on the SB/SE web pages on [irs.gov](http://irs.gov). The link explains what accessibility is, by definition, and the web site contains ac-



cessibility features in place. The IRS will continue to work to ensure features remain § 508 compliant.

The following assistive technologies are provided on the SB/SE irs.gov website:

- Text Descriptions Provided for Images and Pictures - When the mouse pointer or pointer alternative moves over an image, a small window pops up to give you a description of the image. This description is also provided to visitors who are using screen readers to access information on the page.
- Style Sheets Used to Format Page Content - The content on the site is designed using cascading style sheets. This allows visitors to disable the formatting provided and apply their own formatting if they choose. Style sheets are disabled within an Internet browser's settings or preferences options. People with a slight visual impairment, who need a larger font size to read comfortably, will find this feature useful.
- Persons using screen-reading devices, who generally cannot directly read documents in PDF format, will find an HTML version of many forms and publications on the IRS site. The IRS plans to make all PDF files accessible. As new publications become available in Acrobat 5.0, which is § 508 compliant, they will be posted on the site.
- Direct links to main sections of each page are provided for those using screen readers. Screen readers tend to read pages from left to right and from top to bottom. The pages in IRS.gov provide internal bookmarks so that screen reader users can jump directly to specific sections of the page. This feature is referred to as a navigation menu bypass.

The IRS is also planning to redesign the website on [www.irs.gov](http://www.irs.gov) to centralize all information for the disabled community and employers who hire individuals with disabilities. The goal of the redesign is to place all messages and information into one location with links to other appropriate sites.

The IRS also accommodates hearing impaired taxpayers by a TTY/TDD telephone access number. Telephone assistance for the hearing impaired is available for individuals with TTY equipment. The toll-free number for this service is 1-800-829-4059. Our EEO office is used as a resource to accommodate deaf or hearing impaired taxpayers with interpreter services. In addition, in many cases, the state agencies we partner with have access to sign language interpreters.

Most IRS products are available in Braille, large print, HTML, and ASCII text for taxpayers who are blind or visually impaired. These products are available from the Alternative Media Center (AMC). The AMC provides products to IRS employees and external customers to accommodate a person with a disability. For the leveraged Small Business Tax Workshops, in some cases, if our partner is notified in advance they will contact the nearest office of the Bureau of Services for the Visually Impaired to arrange accommodations. The visually impaired are instructed to bring a laptop to the seminar and they are given the workshop CD provided by the IRS. This permits them to zoom to the level that suits their

visual capacity. The majority of the publications that we reference in our workshops can be downloaded from the internet and converted to accessible versions of IRS Tax Publications. Each product set has been compressed to a WinZip Self-Extracting file and is in an “executable” (.exe) format. Each executable file (product set) contains two items: a product file(s) in text-only and product file(s) in .brf format for Braille embossing. The text-only files can be used easily with screen enlargers, screen readers, refreshable Braille displays, and most other accessibility software.

In summary, outreach and education to the disabled community is an important focus for IRS. The IRS will continue efforts to improve all internal and external communications by identifying enhanced educational opportunities for outreach to the disabled small business owner and those who hire the disabled.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate is encouraged by the steps the IRS is taking toward accessibility, outreach, and education for taxpayers with a disability. We applaud the IRS for partnering with internal and external stakeholders to reach out to taxpayers with disabilities, centralizing all information on [irs.gov](http://irs.gov) concerning these taxpayers, planning to assess guidelines regarding disability tax incentives for business taxpayers, and including examples in the enhanced guidelines to better illustrate what does or does not qualify. However, the National Taxpayer Advocate would encourage SB/SE to adopt a more focused approach when reaching out to entrepreneurs with disabilities and employers of people with disabilities.

### *The IRS Multi-Component Disability Outreach and Education Strategy*

The IRS’s disability outreach strategy focuses primarily on educating the business community about the availability of tax incentives for hiring workers with a disability. Although this is an important component, limiting the strategy in this way fails to address the growing need for assistance to taxpayers with a disability who are self-employed or starting their own businesses.<sup>35</sup> The IRS should use its partnerships and resources not only to educate employers on tax incentives for hiring employees with a disability, but also to educate entrepreneurs with a disability on starting a business, thereby, assisting taxpayers with a disability to secure a foothold in America’s labor market.

<sup>35</sup> Department of Labor, *Business Ownership - Cornerstone of the American Dream*, at <http://www.dol.gov/odep/pubs/business/business.htm>. Peter David Blanck, Leonard A. Sandler, James L. Schmeling, Helen A. Scharz, *The Emerging Workforce of Entrepreneurs with Disabilities: Preliminary Study of Entrepreneurship in Iowa* 85 Iowa, L. Rev. 1583 (Aug. 2000). This article suggests the following statistics indicate an increase in the number of people with a disability who have become entrepreneurs or small business owners since the passage of the ADA. For example, workers with disabilities are nearly twice as likely to be self-employed as workers who are not disabled, and the 1990 national census reported 12 percent of people with disabilities had self-employment and small business experience, as compared with eight percent of people without disabilities. Moreover, in 1994, more than 14 percent of individuals with disabilities owned or worked for a small business, whereas eight percent of individuals without disabilities did so.

### *The IRS Educational Opportunities for Disabled Taxpayers*

Although it is important for SB/SE to utilize its partnerships with national disability organizations, it should not entirely rely on these organizations to educate taxpayers with a disability on small business and self employment issues, but rather should use these organizations to target this population. It seems logical that the IRS would possess the most knowledge and information regarding these issues and would therefore be best at delivering this complex information. Further, the IRS, and not third party organizations, would appear to be the most reliable source of information about tax issues. However, if the IRS is not going to deliver this complex information directly, it should at least test what methods these partners are using to deliver this complex information thereby, ensuring the information is being delivered in the most effective way possible.

The National Taxpayer Advocate commends the IRS's involvement in the REI Tour, which TAS is proud to be involved in. However, the tour focuses on educating taxpayers with a disability and their employers on tax deductions and credits for which they may qualify. While these are important issues, SB/SE should try to utilize the tour to target entrepreneurs with a disability and provide them with specific information on starting and managing a business. This approach could provide SB/SE with a relatively easy way to reach out to the disability community face-to-face, and to supplement what is now a deficient face-to-face outreach program.<sup>36</sup> Moreover, SB/SE could distribute its materials, in accessible format, throughout the REI tour and advertise a live outreach session addressing business issues that will be conducted in the future.

### *The IRS Technology and Taxpayer Assistance*

The National Taxpayer Advocate acknowledges the important steps SB/SE is taking toward making its website and information accessible to taxpayers with a disability. However, for these accommodations to be useful, the IRS must ensure that taxpayers are aware of services such as the AMC.<sup>37</sup> It would only make sense for SB/SE to advertise this service, and others, in its outreach initiative. Moreover, rather than putting the burden on the taxpayer to reformat the pages on irs.gov, the IRS should incorporate accessibility features such as changing font size, color, and a speech component into the site. This approach would provide taxpayers with a disability the option of manipulating the site to meet their needs. Implementing these accessibility features would be easier than expecting the taxpayer to reformat the website, especially since not all taxpayers have the technology or knowledge to conduct this task. Not only does SB/SE suggest the taxpayer reformat the website to be

<sup>36</sup> SB/SE response to TAS research request (Oct. 26, 2007). SB/SE recently canvassed its Stakeholder Liaison Area Managers for the number of workshops conducted by the Small Business Administration, even though it generally does not track this information, through SCORE (an organization that focuses on small business counseling) program and Small Business Development Centers (SBDCs). These are the two primary organizations that conduct the workshops on behalf of SB/SE. The Stakeholder Liaison Area Managers determined, on average, 45 workshops are conducted monthly in 33 states plus the District of Columbia. It is alarming that there are numerous states where no workshops are being conducted for taxpayers.

<sup>37</sup> National Taxpayer Advocate 2006 Annual Report to Congress 394; taxpayers can request from the IRS's Alternative Media Center (AMC) any form, publication, notice, or bill in an alternative format, such as Braille or large print. IRS, *Alternative Media Center*, <http://www.irs.gov/help/page/0,,id=13148,00.html>.

accessible, but also suggests that taxpayers who are blind or visually impaired bring their own accessible laptops to SB/SE's live sessions to make the materials accommodating. This does not seem like a reasonable accommodation because many blind or visually impaired taxpayers may not have an accessible laptop, especially since the cost of this equipment can be high.<sup>38</sup>

Although using technology to communicate with taxpayers is essential, a successful communication strategy for this diverse population requires a multi-faceted approach, which includes developing a user-friendly webpage and providing materials in accommodating formats, but also conducting face-to-face live outreach sessions. Because the preferred form of communication for taxpayers with disabilities varies according to their needs, it is vital that SB/SE balance technology with direct contact.

## Recommendations

The National Taxpayer Advocate encourages the IRS to adopt the following recommendations to develop a more successful approach to communicating and assisting entrepreneurs with a disability, and thereby promoting a strong economic future for the disability community.

- Utilize the REI Tour as an vehicle to target outreach to self-employed taxpayers and entrepreneurs with a disability and their community.
- Follow up the REI Tour outreach with face-to-face live outreach sessions.
- Provide accessible laptops at live outreach sessions, rather than requiring taxpayers to bring their own.
- Use the REI Tour to educate taxpayers regarding the accommodations the IRS provides taxpayers with a disability.
- Include information regarding IRS accommodations for taxpayers with a disability in IRS notices.
- Provide SB/SE's internet small business classroom materials as streaming translation in American Sign Language (ASL) for taxpayers who are deaf or hard-of-hearing.
- Redesign irs.gov so taxpayers have numerous options that will allow them to manipulate the font size and color, or use a speech option to meet their individual needs.

<sup>38</sup> Freedom Scientific, at <http://www.freedomscientific.com>. Screen reading programs and screen magnification programs for the blind and visually impaired can be expensive to purchase. This is an especially important point since the median adjusted gross income (AGI) for taxpayers with a disability is \$19,100, compared to \$33,800 for taxpayers without a disability. W&I Research, *Characteristics of Disabled Taxpayers Age 18-59: Study of Filing Patterns and Preferences of Receiving Tax Information and Services 20* (May 4, 2007).

MSP  
#13**Exempt Organization Outreach and Education****Responsible Official**

Steven T. Miller, Commissioner, Tax Exempt and Government Entities Division

**Definition of Problem**

The U.S. tax-exempt sector consists of more than 1.6 million organizations (not including most churches), approximately one million of which are Internal Revenue Code (IRC) § 501(c)(3) organizations.<sup>1</sup> These organizations are diverse in size, ranging from large hospitals and universities to small volunteer-run charities.

The tax law imposes certain limitations on the activities of exempt organizations (EO). These substantive legal requirements are complex. The IRS requires extensive information from tax-exempt entities on complicated forms, both when the organizations are created and on an annual basis afterward.

The IRS has increased enforcement actions against EOs.<sup>2</sup> At the same time, resources devoted to EO education and outreach, which were never adequate, continue to decline.<sup>3</sup> These resources are insufficient to meet the need and have undoubtedly contributed to noncompliance. More and better education and outreach, developed with EOs' input, would help the IRS better leverage its limited resources by reducing inadvertent noncompliance and processing time.

**Analysis of Problem****Background*****Requirements for Exemption under IRC § 501(c)(3)***

To be tax-exempt under IRC § 501(c)(3), an organization must be organized and operated exclusively for exempt purposes,<sup>4</sup> and none of its earnings may inure to any private individual. Further, no substantial part of its activities may consist of attempts to influence legislation (except as otherwise provided in IRC § 501(h)), and such an organization may

<sup>1</sup> *Tax-Exempt Charitable Organizations: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 110<sup>th</sup> Cong., 1<sup>st</sup> Sess. (July 24, 2007) (statement of Steven T. Miller, Commissioner, Tax-Exempt and Government Entities Division).

<sup>2</sup> *Id.*

<sup>3</sup> IRS, *Tax Exempt and Government Entities Business Performance Review* 6 (May 9, 2007).

<sup>4</sup> The exempt purposes set forth in IRC § 501(c)(3) are charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition, and the preventing cruelty to children or animals.

not intervene in any political campaign. These requirements have been interpreted in numerous court decisions, Revenue Rulings, and other IRS administrative materials.

In addition to meeting the foregoing requirements, an organization must apply for recognition of exemption with the IRS to be exempt under IRC § 501(c)(3).<sup>5</sup> Only churches, their integrated auxiliaries, and conventions or associations of churches and organizations that are not private foundations, and whose gross receipts in each taxable year are normally not more than \$5,000, are excused from the application requirement.<sup>6</sup>

Organizations exempt under IRC § 501(c)(3) must generally file an annual information return, Form 990 or Form 990EZ.<sup>7</sup> Form 990 is nine pages long and has a 57-page instruction book, of which 45 pertain specifically to Form 990.<sup>8</sup> The IRS estimates that an organization will spend an average of 152 hours and 20 minutes preparing Form 990.<sup>9</sup>

### **Current Exempt Organization Education and Outreach**

The IRS's Tax Exempt and Government Entities (TE/GE) division devoted "significant resources" in fiscal year (FY) 2007 to the development of a web-based, interactive workshop for small and mid-sized EOs, which went live in January 2007.<sup>10</sup> The workshop, *Stay Exempt: Tax Basics for 501(c)(3)s*, consists of five modules, running about 30 to 60 minutes long.<sup>11</sup> StayExempt.org received nearly 114,500 visits from its debut through October 11, 2007.<sup>12</sup>

In FY 2006, the IRS held 18 workshops for small and mid-size EOs, reaching roughly 2,000 individuals.<sup>13</sup> In calendar year 2007, the IRS offered eight such workshops in November and December.<sup>14</sup> These workshops were limited in geographic scope, being held in Salt

<sup>5</sup> IRC § 508(a). See Most Serious Problem, *Determination Letter Process*, *infra*.

<sup>6</sup> IRC § 508(c)(1).

<sup>7</sup> See IRC § 6033(a)(1). Tax-exempt organizations whose annual gross receipts do not normally exceed \$25,000 are not required to file an annual information return. See Announcement 82-88, 1982-25 IRB 23. Such small organizations may, however, be required to file Form 990-N, an annual electronic notice, beginning in 2008. IRC § 6033(i). The National Taxpayer Advocate has recommended that IRC § 6033(a)(3)(A)(ii) be amended to increase the information return filing threshold to \$50,000 and provide that the filing threshold be adjusted for inflation in subsequent years. See National Taxpayer Advocate 2006 Annual Report to Congress 483-495 (Key Legislative Recommendation: Increase the Exempt Organization Information Return Filing Threshold).

<sup>8</sup> IRS, Form 990, *Return of Organization Exempt from Income Tax* (2006); IRS, *Instructions for Form 990 and Form 990-EZ, Short Form of Organizations Exempt from Income Tax* (2006).

<sup>9</sup> This estimate includes time spent on recordkeeping, learning about the law or the form, preparing the form, and copying, assembling, and sending the form to the IRS. The preparation of each of Form 990's related schedules, Schedules A and B, is estimated to take a total of 100 hours and 17 minutes and seven hours and 40 minutes, respectively. IRS, *Instructions for Form 990 and Form 990-EZ* 55 (2006).

<sup>10</sup> IRS, *Tax Exempt and Government Entities Business Performance Review* 23 (Feb. 6, 2007).

<sup>11</sup> The modules are: (1) *Tax-Exempt Status – How can you keep your 501(c)(3) exempt?*; (2) *Unrelated Business Income – Does your organization generate taxable income?*; (3) *Employment Issues – How should you treat your workers for tax purposes?* (4) *Form 990 – Would you like to file an error-free return?*; and (5) *Required Disclosures – To whom do you have to show your records?* IRS, *Stay Exempt: Tax Basics for 501(c)(3)s*, at <http://www.stayexempt.org>.

<sup>12</sup> The number cited is the total unique website visits. A unique website visit is the first visit from a computer per month. Tax Exempt/Government Entities Division, response to TAS research request (Oct. 15, 2007).

<sup>13</sup> IRS, *FY 2007 Exempt Organizations Implementing Guidelines* 8 (Nov. 7, 2006).

<sup>14</sup> IRS News Release, *IRS to Hold Workshops for Small and Mid-Sized 501(c)(3) Exempt Organizations* (Oct. 26, 2007).

Lake City, Utah; Columbia, South Carolina; and Sacramento, California.<sup>15</sup> The exact number of attendees is not yet available but, as each workshop's capacity was 200,<sup>16</sup> they could have reached a maximum of 1,600 individuals (out of the 650,000 small tax-exempt organizations on record with the IRS).<sup>17</sup> To provide these workshops, the IRS charges small and mid-size EOs, those that can least afford it and are most in need of education, a non-refundable registration fee of \$45 per person to attend and receive a related text and IRS forms and publications.<sup>18</sup>

TE/GE also held six EO phone forums in FY 2007,<sup>19</sup> reaching 1,368 individuals<sup>20</sup> and addressing such topics as gaming and the draft of the redesigned Form 990.<sup>21</sup>

TE/GE released 19 editions of its EO electronic newsletter, *EO Update*, from January through September 2007.<sup>22</sup> The newsletter reaches 37,833 subscribers,<sup>23</sup> a small number given the potential audience of 1.6 million organizations.

TE/GE also participates in the IRS Nationwide Tax Forums. At the 2007 Tax Forums, TE/GE held an EO workshop on completing Form 990 and three EO seminars, *How to Lose Your Tax-Exempt Status (Without Really Trying)*, *Can a Tax-Exempt Organization Have Business Income?*, and *The Draft Redesigned Form 990*.<sup>24</sup>

TE/GE provides speakers for other EO panels, conferences, and events as well, but these speaking engagements arise only when TE/GE responds to invitations; it does not initiate them.<sup>25</sup> TE/GE bases its decision not to seek EO speaking engagements on its limited staffing.<sup>26</sup> However, because the events are externally driven, the number of engagements and organizations reached can vary greatly. For example, the number of EO customers reached by TE/GE in the first quarter of FY 2007 fell 35 percent compared to the same period in FY 2006 due to a drop in speech requests.<sup>27</sup> As a result of this first quarter decrease, TE/GE reduced its projection for EO customers reached in FY 2007 from 30,525 to 25,000,<sup>28</sup> but

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

<sup>17</sup> IRS News Release, IRS to Notify Small Tax-Exempt Organizations of New Information Reporting Requirement (July 12, 2007).

<sup>18</sup> IRS News Release, IRS to Hold Workshops for Small and Mid-Sized 501(c)(3) Exempt Organizations (Oct. 26, 2007).

<sup>19</sup> TE/GE response to TAS research request (Oct. 10, 2007).

<sup>20</sup> *Id.*

<sup>21</sup> See IRS, *EO Update*, Issue 2007-5 (Feb. 16, 2007); IRS, *EO Update*, Issue 2007-10 (May 2, 2007); IRS, *EO Update*, Issue 2007-14 (June 29, 2007).

<sup>22</sup> See IRS, *EO Update Archive - 2007*, at <http://www.irs.gov/charities/article/0,,id=166198,00.html>.

<sup>23</sup> Information received from Tax Exempt/Government Entities Division, (Nov. 6, 2007).

<sup>24</sup> See Tax Exempt and Government Entities (TE/GE) Times 12 (Nov. 2007).

<sup>25</sup> IRS, *Tax Exempt and Government Entities Business Performance Review 23* (Feb. 6, 2007).

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> IRS, *Tax Exempt and Government Entities Business Performance Review 23* (Feb. 6, 2007). See also *Tax Exempt and Government Entities Business Performance Review 22* (Sept. 5, 2007).



ultimately reached 39,338 EO customers in FY 2007<sup>29</sup> (up almost 7,000 from 32,368 in FY 2006).<sup>30</sup> Even with this increase, TE/GE's FY 2007 education and outreach efforts reached only approximately 2.5 percent of the EO sector.<sup>31</sup>

The effect of any decrease in the number of EO speech requests on the number of EOs that receive TE/GE's message is much greater than these numbers reflect. TE/GE measures EO customers reached at events by the number of attendees. Yet, a comment made by a TE/GE representative at a single conference has a ripple effect that may reach dozens or even hundreds of organizations not in attendance.<sup>32</sup> Speeches thus present a cost-effective way to leverage limited resources, a method of which TE/GE is not taking full advantage.

### Focusing on Enforcement to the Exclusion of Education

The IRS's emphasis with regard to EOs is increasingly on compliance and enforcement. The EO examination rate increased by 43 percent from FY 2005 to FY 2006.<sup>33</sup> In FY 2006, the IRS examined 7,079 EO returns, the highest level since FY 2000.<sup>34</sup>

TE/GE has strengthened its EO examination program by shifting resources to it in recent years.<sup>35</sup> By the end of FY 2006, TE/GE had 507 full-time equivalents (FTE)<sup>36</sup> in EO examination, up from 394 at the close of FY 2003, an increase of almost 29 percent.<sup>37</sup> In contrast, EO education and outreach FTEs ranged from 2.3 as of December 2006<sup>38</sup> to 12.5 as of September 2007.<sup>39</sup> The number of EO education and outreach FTEs has remained stagnant, just breaking double digits, for the last three fiscal years.<sup>40</sup> TE/GE only plans to increase its EO customer outreach and education staff by three in FY 2008.<sup>41</sup>

<sup>29</sup> Information received from TE/GE (Nov. 6, 2007).

<sup>30</sup> IRS, *Tax Exempt and Government Entities Business Performance Review 23* (May 9, 2007).

<sup>31</sup> Of 1.6 million EOs, 39,338, or 2.5 percent, were reached in FY 2007.

<sup>32</sup> See Advisory Committee on Tax Exempt and Government Entities, *The "RIPPLE" Project: Reviewing IRS Policies and Procedures to Leverage Enforcement: Recommendations to Enhance Exempt Organization's (EO) Enforcement and Compliance Efforts V-17-V-18* (June 9, 2004).

<sup>33</sup> *Tax-Exempt Charitable Organizations: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 110<sup>th</sup> Cong., 1<sup>st</sup> Sess. (July 24, 2007) (statement of Steven T. Miller, Commissioner, Tax-Exempt and Government Entities Division).

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

<sup>36</sup> IRS, *Standard 2008-01 Financial Management Codes Handbook* (Sept. 28, 2007) states that "full-time equivalent" (FTE) reflects the total number of regular straight-time hours (i.e., not including overtime or holiday hours) worked by employees divided by the number of compensable hours applicable to each fiscal year. Annual leave, sick leave, and compensatory time off and other approved leave categories are considered to be "hours worked" for purposes of defining FTE employment. OMB Circular A-11, § 32.4(b) provides a list of compensable days (with associated hours) for FY 2005 through FY 2008. The number of compensable days (with associated hours) for fiscal year 2006 is 260 days resulting in 2,080 hours in a FTE. (Sept. 28, 2007).

<sup>37</sup> *Tax-Exempt Charitable Organizations: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 110<sup>th</sup> Cong., 1<sup>st</sup> Sess. (July 24, 2007) (statement of Steven T. Miller, Commissioner, Tax-Exempt and Government Entities Division).

<sup>38</sup> IRS, *Tax Exempt/Government Entities Business Performance Review 23* (Feb. 6, 2007).

<sup>39</sup> Information received from TE/GE (Nov. 6, 2007).

<sup>40</sup> TE/GE had 12 full-time equivalents in EO education and outreach in FY 2005 and 11.9 in FY 2006. IRS, *Tax Exempt and Government Entities Business Performance Review 21* (May 9, 2007).

<sup>41</sup> Information received from TE/GE (Nov. 6, 2007).

TE/GE's EO education and outreach budget for FY 2007 was likewise dwarfed by that for EO examinations. Out of a total EO budget of roughly \$85.4 million, the division allocated approximately \$49.4 million to EO examinations, over 41 times the roughly \$1.2 million for EO customer education and outreach.<sup>42</sup>

Enforcement is certainly necessary, but the IRS must strike a better balance between enforcement and education in the EO arena. In the words of the IRS Oversight Board, "We cannot shift resources to pursue those who knowingly avoid taxes while neglecting the needs of honest taxpayers attempting to comply with a complex tax code."<sup>43</sup> It is patently unfair to burden EOs with both stringent enforcement and inadequate education.

Rather than viewing education and enforcement as at odds, the IRS should recognize education as a necessary ingredient of a good enforcement program. As the Advisory Committee on Tax-Exempt and Government Entities (ACT) has noted, "An essential element of any oversight agency's enforcement and compliance program is its ability to regularly educate the organizations it oversees so that the organizations can ensure they are in compliance."<sup>44</sup> In the tax-exempt sector, just as in the for-profit sector, there is a segment of "taxpayers" that will comply with their obligations given proper education and assistance. In fact, given that only one percent of EOs under the IRS's jurisdiction are subject to audit each year, their tax law compliance is largely a matter of "voluntary obedience."<sup>45</sup> It is a misuse of TE/GE's limited resources to emphasize enforcement if outreach and education would bring taxpayers into compliance.

TE/GE's education and outreach budget, always woefully inadequate for the large and diverse sector it serves, is rendered more so in light of the significant changes wrought by the Pension Protection Act of 2006<sup>46</sup> and the outreach needed to properly educate organizations about them. The Independent Sector, a membership organization representing more than 575 nonprofits, cautions that these substantive changes to the law governing EOs make IRS outreach more important than ever.<sup>47</sup>

<sup>42</sup> Information received from TE/GE (Nov. 6, 2007).

<sup>43</sup> IRS Oversight Board, *FY2006 IRS Budget Special Report 7* (Mar. 2005).

<sup>44</sup> Advisory Committee on Tax-Exempt and Government Entities, *The "RIPPLE" Project: Reviewing IRS Policies and Procedures to Leverage Enforcement: Recommendations to Enhance Exempt Organization's (EO) Enforcement and Compliance Efforts V-17-V-18* (June 9, 2004).

<sup>45</sup> Advisory Committee on Tax-Exempt and Government Entities, *Proposal for an Exempt Organizations Voluntary Compliance Program 4* (June 13, 2007).

<sup>46</sup> Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (2006).

<sup>47</sup> "Congress' recent passage of substantive changes to the tax laws governing exempt organizations has made IRS outreach more important than ever.... Without sufficient education of charitable organizations about the new laws, however, the provisions will not achieve their intended purpose." Letter from Diana Aviv, President and CEO, Independent Sector, to Sen. Richard Durbin, Chair, Senate Appropriations Subcommittee on Financial Services and General Government, Sen. Sam Brownback, Ranking Member, Senate Appropriations Subcommittee on Financial Services and General Government, Rep. Jose Serrano, Chair, House Appropriations Subcommittee on Financial Services and General Government, and Rep. Ralph Regula, Ranking Member, House Appropriations Subcommittee on Financial Services and General Government (Apr. 10, 2007).

### Increasing Reliance on Electronic Education and Outreach

TE/GE increasingly uses electronic means to deliver outreach and education. TE/GE spent approximately \$338,800 at the end of FY 2006 and the beginning of FY 2007, on its web-based training program.<sup>48</sup> Roughly 22 percent of its total FY 2007 EO education and outreach expenditures are attributable to the web-based training program.<sup>49</sup> The decision to rely on electronic forms of education in lieu of in-person methods has been made without systematically sampling the educational needs and preferences of EOs or researching how such entities use the Internet. Such research is particularly important given the wide range of EOs—from small, unsophisticated groups to professionally-advised, complex organizations. Further, TE/GE should do more to measure the effectiveness of its electronic outreach. Counting hits on a website provides no insight as to whether the visitors found the site helpful. The user survey at the end of each StayExempt.org module is a step in the right direction, but surveys should not be the only method of measuring effectiveness.

### Decreased Telephone Access to Tax-Exempt Specialists

Prior to October 1, 2006, TE/GE provided toll-free telephone assistance to EOs.<sup>50</sup> However, demand for this valuable service significantly exceeded capacity. TE/GE assistors answered only about 60 percent of calls in FYs 2004 and 2005,<sup>51</sup> and that number fell to 57 percent in FY 2006.<sup>52</sup> In an attempt to enhance customer service, TE/GE transferred the toll-free telephone operation to the IRS's Wage and Investment (W&I) division on October 1, 2006.<sup>53</sup>

This transfer involved a change in how the more complex tax-exempt questions are handled. Prior to June 30, 2006, such calls would have been routed to tax-exempt specialists who would either answer a question immediately or research it for later response. The W&I assistors now send such calls through an internal email system, R-mail, to experienced TE/GE employees for telephone response.<sup>54</sup> The average response time for the nearly 5,200 EO R-mail questions received in the first nine months of FY 2007 was 2.6 business days.<sup>55</sup> The tax-exempt specialists handling R-mails have no opportunity to obtain feedback or clarification from the questioner before researching responses. Thus, there is a real risk that the replies may not actually answer callers' questions.

The transfer of the toll-free line to W&I has resulted in improvements on certain customer service measures such as telephone hours<sup>56</sup> and level of service (an indicator of

<sup>48</sup> TE/GE response to TAS research request (Oct. 10, 2007).

<sup>49</sup> *Id.*

<sup>50</sup> IRS, *Tax Exempt and Government Entities Business Performance Review* 36 (May 9, 2007).

<sup>51</sup> National Taxpayer Advocate 2005 Annual Report to Congress 303.

<sup>52</sup> IRS, *Tax Exempt and Government Entities Business Performance Review* 37 (May 9, 2007).

<sup>53</sup> *Id.* at 36.

<sup>54</sup> IRS, *Tax Exempt and Government Entities Business Performance Review* 38 (May 9, 2007).

<sup>55</sup> *Id.*

<sup>56</sup> Telephone hours increased 18 percent from 51,214 in FY 2006 to 60,338 in FY 2007. Information received from TE/GE (Nov. 6, 2007).

accessibility).<sup>57</sup> Telephone quality for the first nine months of FY 2007, however, was down 16 percent from the same period in the prior fiscal year.<sup>58</sup> TE/GE is taking steps to improve quality, such as reviewing training material to identify areas requiring more comprehensive training.<sup>59</sup>

The decline in telephone quality and the lack of real-time access to tax-exempt specialists are disturbing given the value of the call center, which is a particularly important resource to EOs that lack professional representation. Moreover, expert toll-free assistance is vital to the efficacy of the exemption determination process.<sup>60</sup> The lack of education and outreach about the requirements for tax-exempt status leads to incomplete and underdeveloped applications, which slows processing and generates more calls from applicants. If TE/GE conducted better outreach about the requirements for exemption at the pre-application stage, organizations would be more likely to learn that they are not good candidates for exempt status and would not seek it. The determinations area provides just one example of the large downstream costs to the IRS of its inadequate EO education.

### Need for More Outreach Targeted at Small Exempt Organizations

TE/GE's education and outreach task is made particularly difficult— but all the more crucial — by the fact that most of these organizations are small entities with modest budgets and volunteer staffs. More than 73 percent of public charities reported annual expenses of less than \$500,000 in 2004.<sup>61</sup> Approximately half of EOs have all-volunteer staffs and another third have fewer than ten employees.<sup>62</sup> These smaller nonprofits frequently lack professional tax guidance and rely on their volunteers to deal with the IRS.<sup>63</sup>

While TE/GE directs some outreach efforts toward small EOs, such as StayExempt.org and small and mid-size EO workshops, these entities require much more attention. Even with a full schedule of 18 workshops, TE/GE reaches only roughly 2,000 individuals at such events

<sup>57</sup> The level of service increased from 57.2 percent for FY 2006 to 67.2 percent for FY 2007, and stood at 85.7 percent from April through September 2007. Information received from Tax Exempt/Government Entities Division (Nov. 7, 2007).

<sup>58</sup> IRS, *Tax Exempt and Government Entities Business Performance Review* 38 (Sept. 5, 2007).

<sup>59</sup> *Id.* The Treasury Inspector General for Tax Administration (TIGTA) has also identified “significant long-term risks that could lead to a drop in overall customer service to tax-exempt customers” in its study of the transfer of the toll-free line from TE/GE to W&I. Based on TIGTA's recommendations, TE/GE committed to modify the agreement between TE/GE and W&I to require: (1) the role of TE/GE technical experts be strengthened to include identification of service requirements and more involvement/approval in maintaining and updating procedures and training, (2) prior TE/GE approval of deviation from the Telephone Operations Manual, (3) W&I to provide TE/GE information about the status of training programs and the number of W&I customer service representatives to be used to answer tax-exempt inquiries, (4) continuation of a separate TE/GE toll-free customer satisfaction survey, and (5) W&I to timely notify TE/GE of operational changes to the call site affecting EOs. Treasury Inspector General for Tax Administration, Ref. No. 2007-10-184, *Improving the Toll-Free Telephone Agreement Would Better Assure Tax-Exempt Customer Needs Will Be Met* 9 (Sept. 18, 2007).

<sup>60</sup> “The contributions of the Call Site in the determinations process cannot be underestimated. The provision of accurate information and direction, particularly at the pre-application stage, can result in more expeditious application processing, an increase in the percentage of applications that are merit closures, and fewer and less intrusive subsequent contacts between [applicants] and determination specialists.” Advisory Committee on Tax-Exempt and Government Entities, *Project “ASPIRE”* I-8 (May 20, 2003).

<sup>61</sup> Independent Sector, *Facts and Figures about Charitable Organizations* 3 (last updated Jan. 4, 2007).

<sup>62</sup> IRS, *TE/GE FY 2005 Strategic Assessment* 3 (Feb. 2, 2005).

<sup>63</sup> *Id.*

each year.<sup>64</sup> While the reach of StayExempt.org is broader than that of the workshops, it may not provide assistance about the subjects most helpful to small organizations or in the most useful form. TE/GE itself has recognized the reliance that small EOs place on TE/GE's toll-free telephone service,<sup>65</sup> yet it has eliminated direct access to tax-exempt specialists and increased the amount of time some organizations must wait for answers to complex questions.<sup>66</sup>

### IRS Comments

The IRS welcomes the National Taxpayer Advocate's continued attention to the important area of customer education and outreach. We respectfully offer, however, the following comments on several of the views expressed above concerning our current customer education and outreach efforts.

In the past few years, EO staffing devoted to education and outreach has not declined, but has remained steady at approximately 12 FTE's per year.<sup>67</sup> Although our FTE have remained constant over the past several years, TE/GE's Customer Education & Outreach (CE&O) has used its resources in innovative ways that actually reach more customers than we were able to reach using traditional, resource-intensive, face-to-face outreach.

The IRS shares the view that small exempt organizations need special help complying with the tax law, and accordingly devotes a significant amount of its CE&O attention to this segment of the EO community. For example:

- The IRS continues to conduct the traditional EO Small and Mid-size Workshops that have been offered to section 501(c)(3) organizations since 2001. The National Taxpayer Advocate states that *"the IRS charges these small and mid-size EOs ... \$45 per person to attend and receive a related text and IRS forms and publications."* In 2004, EO started charging a registration fee for its workshops. In 2007, because of a GAO decision<sup>68</sup>, EO had less flexibility on the fee and was forced to raise it from \$35 last year to \$45. This fee is still considerably lower than comparable programs offered outside the government.
- The IRS also has expanded its outreach to this population through StayExempt.org, an interactive web-based training program. The topics and content of StayExempt.org are patterned after the successful workshop program noted above.

<sup>64</sup> IRS, *FY 2007 Exempt Organizations Implementing Guidelines* 8 (Nov. 7, 2006).

<sup>65</sup> IRS, *TE/GE FY 2005 Strategic Assessment* 3 (Feb. 2, 2005) ("Such [smaller] exempt organizations represent a major source of the calls for tax law assistance to TE/GE's Customer Account Services operation in Cincinnati.").

<sup>66</sup> See Treasury Inspector General for Tax Administration, Ref. No. 2007-10-184, *Improving the Toll-Free Telephone Agreement Would Better Assure Tax-Exempt Customer Needs Will Be Met* 9 (Sept. 18, 2007).

<sup>67</sup> FY 2005-12; FY 2006-11.9; FY 2007-12.5.

<sup>68</sup> Government Accountability Office, B-306663, *Contractors Collecting Fees at Agency-Hosted Conferences* (Jan. 4, 2006).

- ◆ The National Taxpayer Advocate states that *“the decision to rely on electronic forms of education in lieu of in-person methods has been made without systematically sampling the educational needs and preferences of EOs or researching how such entities use the Internet.”* Rather than replacing in-person methods, StayExempt.org was developed to expand the reach of our existing workshops and speaking events to those who are not able to attend face-to-face training, and to reinforce the material taught to those who do attend. We believe StayExempt.org is entirely consistent with the National Taxpayer Advocate’s previous recommendation<sup>69</sup> that *“The IRS should investigate cost effective ways to expand the workshops’ coverage—such as ... developing a ‘virtual workshop’ for the IRS website....”* We were pleased that the National Taxpayer Advocate saw the value of a project we were developing at the time. We believe StayExempt.org has had the desired result having reached over 114,000 viewers since its inception.

The National Taxpayer Advocate also states that *“TE/GE should do more to measure the effectiveness of its electronic outreach. Counting hits on a website provides no insight as to whether the visitors found the site helpful. The user survey at the end of StayExempt.org module is a step in the right direction, but surveys should not be the only method of measuring effectiveness.”* EO has found the feedback from the StayExempt.org survey extremely helpful. Not only have the ratings been consistently high – 90 percent of users rate the site as either ‘effective’ or ‘very effective’ – but the written comments also provide helpful feedback from the users. A separate survey, which targets small organizations that will begin to file the new e-Postcard (see below), also asks questions about organizations’ awareness of StayExempt.org. and their ability to access the Internet.

- ◆ The National Taxpayer Advocate states that *“StayExempt.org may not provide assistance about the subjects most helpful to small organizations or in the most useful form.”* However, the National Taxpayer Advocate has not shown that StayExempt.org is not helpful or that other subjects or forms of outreach would be more useful. As noted above, users of StayExempt.org consistently rate the on-line workshop as effective. Moreover, on-line delivery enables us to reach many customers at their own pace and at a place and time of their choosing. This would not be possible with more traditional forms of delivering education and outreach.
- Over the years, TE/GE’s CE&O, the office responsible for developing much of the material that is posted on the Charities and Non-Profits pages of IRS.gov, has developed materials specifically for smaller organizations. For example, the Life Cycle of a Public Charity, which was developed in conjunction with the Advisory Committee of TE/GE, provides information about points of intersection between organizations and the IRS. The content includes explanatory information, and links to forms that an organization

<sup>69</sup> National Taxpayer Advocate 2005 Annual Report to Congress 306.



may need to file with the IRS. The materials cover five stages<sup>70</sup> in an organization's life cycle. In September 2007, the Charities and Non-Profit page ranked number 22 of all IRS.gov pages, following generically-used pages such as the 'IRS landing page,' 'IRS Search page,' 'Forms and Instructions,' and 'Publications and Notices.'

- The National Taxpayer Advocate states that *"if TE/GE conducted better outreach about the requirements for exemption at the pre-application stage, organizations would be more likely to learn that they are not good candidates for exempt status and would not seek it."* Determination statistics indicate that the IRS denies less than 0.2 percent of organizations applying for tax exemption; it therefore does not appear that the wrong candidates are applying. The IRS does believe that the quality of the applications filed can be improved. To this end, we have developed Cyber Assistant, a web-based tool that we plan to roll out this year. Cyber Assistant, similar to tax-preparation software, is designed to help organizations complete exemption applications. It will guide an applicant through the application process while also educating the applicant about the duties and responsibilities that go along with tax-exempt status.
- Starting in 2008, small tax-exempt organizations have a new annual filing requirement. The IRS expects that up to 650,000 organizations could be affected by this new requirement. CE&O has been aggressively communicating this message, working with stakeholders, the media, and other parts of the Service. One piece of the communication effort involved a mailing in July 2007 to the 650,000 organizations, alerting them to the new requirement. The mailing urged recipients interested in more information to go to IRS.gov and, specifically, to *EO Update*. This is our electronic newsletter with information for tax-exempt organizations and those who represent them. In the four months since the mailings began, over 17,000 new subscribers have signed up for *EO Update*. The IRS believes that many of these are small organizations who learned about this educational vehicle through the e-Postcard mailing. Now, in subsequent *EO Updates*, they will learn of workshops, new publications and other educational opportunities and materials.
- The IRS continues to develop and deliver new written materials geared to the needs of small and mid-size charities. Publication 4220, *Applying for 501(c)(3) Tax-exempt Status* and Publication 4221, *Compliance Guide for 501(c)(3) Public Charities*, are two examples of publications written primarily for small and mid-size charities.

The National Taxpayer Advocate states that *"TE/GE's FY 2007 education and outreach efforts reached only approximately 2.5 percent of the EO sector."* This figure represents taxpayers reached by only one of the IRS's numerous outreach channels, specifically the 39,338 EO customers reached through face-to-face efforts. It does not include customers reached via

<sup>70</sup> Starting Out: Creating an organization under state law, acquiring an employer identification number, and identifying the appropriate federal tax classification; Applying for Exemption: Acquiring, completing, and submitting application forms; how the IRS processes applications; and getting help from the IRS during the application process; Required Filings: Annual exempt organization returns, unrelated business income tax filings, and other returns and reports that an organization may have to file; Ongoing Compliance: How an organization can avoid jeopardizing its tax-exempt status, disclosure requirements, employment taxes, and other ongoing compliance issues; and Significant Events: Audits, private letter rulings, and termination procedures.



*EO Update* (almost 38,000), for example, or those viewing StayExempt.org (approximately 114,500). Moreover, these efforts – particularly *EO Update* – have a significant multiplier effect as the content of our messages is often repeated in the tax press and disseminated to an even broader audience.

Finally, the IRS joins the National Taxpayer Advocate in recognizing “*education as a necessary ingredient of a good enforcement program.*” All EO enforcement projects include CE&O involvement. Enforcement letters, questionnaires, project proposals, and final reports are reviewed and edited by CE&O to ensure the content is clear and easily understood by the reader. Many compliance projects include an educational component, such as Fact Sheet 2006-17: *Election Year Activities and the Prohibition on Political Campaign Intervention for Section 501(c)(3) Organizations*, or Revenue Ruling 2006-27 regarding Down-payment Assistance.

### Taxpayer Advocate Service Comments

The National Taxpayer Advocate commends TE/GE’s Customer Education and Outreach (CE&O) office for its efforts to educate and reach out to exempt organizations (EOs). The National Taxpayer Advocate also believes that the division can and should do more to help EOs, particularly small organizations, to comply with the complex requirements to which they are subject.

CE&O has done much with few resources, but cannot adequately carry out its mission without better funding. TE/GE allocated only approximately \$1.2 million or 1.4 percent of its \$85.4 million FY 2007 EO budget to education and outreach.<sup>71</sup> The number of EO education and outreach FTEs has stagnated at approximately 12 for the last three fiscal years<sup>72</sup> while the number of EOs has grown by more than 70,000 per year.<sup>73</sup> Twelve FTEs are simply not enough to carry on the important work of EO education and outreach, regardless of how cost effective and innovative the new products are. Further, the IRS should properly fund its recognition of the EO education and outreach as a vital component of a strong enforcement program. While the National Taxpayer Advocate acknowledges the EO CE&O and EO Examination units of TE/GE work together at times, that fact does not, as the IRS suggests in its response, demonstrate appreciation of education and outreach as a necessary ingredient of a good enforcement program where the budget disparity between the two units is more than 41 to one.<sup>74</sup>

CE&O has leveraged its limited resources through increased use of electronic means of education and outreach. The National Taxpayer Advocate does not oppose electronic

<sup>71</sup> Information received from TE/GE (Nov. 7, 2007).

<sup>72</sup> Information received from TE/GE (Nov. 6, 2007); IRS, *Tax Exempt and Government Entities Business Performance Review 21* (May 9, 2007).

<sup>73</sup> Remarks of Steven T. Miller, Commissioner, Tax Exempt and Government Entities, IRS, before the Philanthropy Roundtable (Dec. 10, 2007).

<sup>74</sup> Information received from TE/GE (Nov. 7, 2007).

outreach as the IRS seems to imply in its response. Rather, the National Taxpayer Advocate believes that electronic education and outreach is an excellent tool that should be used in conjunction with, not to supplant, face-to-face and non-electronic outreach. For example, the Charities and Non-Profits page of the IRS website contains many useful materials, but the IRS needs to proactively distribute hard copies of those materials rather than wait for EOs to view them online. Moreover, the IRS must obtain better data on EOs' access to the Internet, how EOs use the Internet, and EOs' willingness and ability to change how they use the Internet before investing further in electronic education and outreach. We commend the IRS for conducting a telephone survey of small EOs that may be required to file the e-Postcard to help determine the readiness of such organizations to electronically file the e-Postcard.<sup>75</sup> We look forward to working with TE/GE to apply the survey results to its outreach and education strategy.

The IRS not only needs to conduct more research on small EOs' electronic capabilities but on EOs in general. This research should include an in-depth study of the service needs and preferences of EOs and a plan to improve service based on the results. The IRS should also undertake a more comprehensive effort to gauge the effectiveness of EO education and outreach, and adapt existing efforts and develop new initiatives based on that information. As small organizations will be randomly sampled by telephone to measure the effectiveness of the IRS's communication regarding the e-Postcard,<sup>76</sup> so should the effectiveness of other IRS outreach activities be studied.

The National Taxpayer Advocate and the IRS agree that small EOs need special help complying with the tax law and that the IRS's workshops for small and mid-size EOs are an important resource for such organizations. Offering virtual workshops to those who cannot attend in-person is a good idea that might be improved with more input from the target audience as to content and format preferences. However, the National Taxpayer Advocate opposes the imposition of a fee to attend the live small and mid-size EO workshops, and urges the IRS to eliminate the fee unless absolutely required by law. The relevance of the Government Accountability Office (GAO) decision cited by the IRS is unclear. That decision holds that, when an agency lacks statutory authority to charge a fee at a conference and retain the proceeds, neither the agency hosting the conference nor a contractor acting on its behalf may do so.<sup>77</sup>

TAS remains willing to assist the IRS's EO outreach and educational efforts in any way it can. TAS looks forward to continued collaboration with the IRS on this front.

<sup>75</sup> See IRS, *Survey of Small Organizations Required to Electronically File Form 990-N*, at <http://www.irs.gov/charities/charitable/article/0,,id=175885,00.html>.

<sup>76</sup> *Id.*

<sup>77</sup> Government Accountability Office, B-306663, *Contractors Collecting Fees at Agency-Hosted Conferences* (Jan. 4, 2006).

## Recommendations

The National Taxpayer Advocate recommends that the IRS take the following steps:

- Conduct an EO Taxpayer Assistance Blueprint (TAB), akin to the servicewide TAB but tailored to EOs, to study their service needs and preferences (by size and type of organization) and develop a plan to improve service to these organizations. The EO blueprint should include a study of the availability of the Internet, how exempt organizations use the Internet (particularly small, volunteer-staffed entities), and their willingness and ability to change how they use the Internet.
- After completion of the EO TAB, conduct further research about the tax-exempt sector, including annual focus groups held at Tax Forums and elsewhere of EO directors, officers, staff, volunteers, and advisors.
- Dedicate a group of employees, from both outreach and compliance functions, entirely to small EOs. Such entities have very different needs from mid-sized and large EOs and require a different approach.
- Staff the tax-exempt telephone line at sufficient levels to generate a high level of service and make training of the staff a high priority, with TE/GE approving the content of the training.
- Provide a mechanism for one-on-one telephone interaction between the tax-exempt specialist assigned to an R-mail and the person asking the question before the specialist begins research, if desired by the questioner or the specialist.
- Develop a directory of institutions that offer courses in nonprofit management and a teaching toolkit for the small to medium nonprofit that instructors at such institutions can use.
- Make a sufficient number of a variety of EO outreach materials available in print (non-electronic format) to preparers, Local Taxpayer Advocates, Stakeholder Partnerships, Education and Communication (SPEC), community foundations, state attorneys general and charities bureaus, and others for distribution.
- Develop a multi-faceted approach to measure the effectiveness of education and outreach activities and use the results to modify existing programs and plan new initiatives.
- Permit small EOs to file the e-Postcard at Taxpayer Assistance Centers (TACs), either on computers provided for taxpayer use (if any) or with the help of TAC assistants, and publicize this alternative widely.
- Train TAC employees to answer questions about how to complete and submit the new e-Postcard.

## MSP #14

**Determination Letter Process****Responsible Official**

Steven T. Miller, Commissioner, Tax Exempt and Government Entities Division

**Definition of Problem**

Charitable organizations are an integral part of our society and economy. Spending by exempt organizations (EOs) accounted for more than 11 percent of the gross domestic product from 1998 through 2002.<sup>1</sup> In 2004, these organizations employed over seven percent of the U.S. workforce.<sup>2</sup> Increasingly, the federal government partners with nonprofits to deliver federal services.<sup>3</sup>

Internal Revenue Code (IRC) § 501(c)(3) provides for federal income tax exemption for charitable, religious, educational, scientific, literary, and other organizations. To claim the exemption, the majority of organizations are required to submit an in-depth application.

Unreasonable delays in the processing of exemption applications have persisted for several years. Three years after the National Taxpayer Advocate addressed such delays in the 2004 Annual Report to Congress, the processing time for many organizations' applications still exceeds the IRS's goal. These delays can have a serious, detrimental effect on charitable organizations' finances and activities, particularly because the IRS does not provide adequate information about when to expect a determination. The IRS has made a number of attempts to fix the problem. While there has been slight improvement on certain measures, much of the progress is attributable to temporary conditions.

**Analysis of Problem****Background**

IRC § 501(c)(3) exempts from federal income tax organizations that are operated exclusively for charitable,<sup>4</sup> religious, educational, scientific, or literary purposes; testing for public

<sup>1</sup> *Oversight of Tax-Exempt Organizations: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 110<sup>th</sup> Cong. 1<sup>st</sup> Sess. (July 24, 2007) (statement of Stanley J. Czerwinski, Director, Strategic Issues, Government Accountability Office).

<sup>2</sup> Independent Sector, *Facts and Figures about Charitable Organizations* 3.

<sup>3</sup> *Oversight of Tax-Exempt Organizations: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 110<sup>th</sup> Cong. 1<sup>st</sup> Sess. (July 24, 2007) (statement of Stanley J. Czerwinski, Director, Strategic Issues, Government Accountability Office).

<sup>4</sup> Charitable purposes include the relief of the poor, the distressed, or the underprivileged; advancement of religion; advancement of education or science; erecting or maintaining public buildings, monuments, or works; lessening the burdens of government; lessening neighborhood tensions; eliminating prejudice and discrimination; defending human and civil rights secured by law; and combating community deterioration and juvenile delinquency. Treas. Reg. § 1.501(c)(3)-1(d)(2).

safety; fostering national or international amateur sports competition; or the prevention of cruelty to children or animals. To be exempt under IRC § 501(c)(3), most organizations are required to apply to the IRS.<sup>5</sup> The IRS will issue a favorable determination letter or ruling to an organization if its application and supporting documents establish that it meets the requirements for exemption.<sup>6</sup>

The application form, Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, is 28 pages long (including a two-page checklist and eight different schedules).<sup>7</sup> The instructions to Form 1023 are 38 pages long,<sup>8</sup> and Publication 557, *Tax-Exempt Status for Your Organization*, which also explains how to complete the application, is 63 pages long.<sup>9</sup> In addition to answering the questions on the form and its schedules, applicants must obtain an employer identification number by filing Form SS-4, *Application for Employer Identification Number*, and submit a variety of supporting documents, including organizing documents (e.g., articles of incorporation), bylaws, financial statements, and descriptions of proposed activities.<sup>10</sup> Organizations must also include the appropriate user fee, currently \$750,<sup>11</sup> with their applications. The IRS estimates that an organization will need to devote approximately 105 hours — or approximately 13 eight-hour work days — to complete the 12 core pages of Form 1023.<sup>12</sup> The time needed to complete the various schedules of Form 1023 ranges from seven hours to approximately 16 hours.<sup>13</sup>

The length and complexity of Form 1023 lead many applicants to make errors that delay the processing of their applications. Moreover, because the IRS dedicates limited resources to EO outreach and education, it receives applications from organizations that are not good candidates for exemption.<sup>14</sup>

As long as a prospective IRC § 501(c)(3) organization files its application within 27 months from the end of the month in which it was created, the exemption will be retroactive<sup>15</sup> and donations will be deductible charitable contributions<sup>16</sup> back to the organization's formation.

<sup>5</sup> IRC § 508(a). Only churches, their integrated auxiliaries, and conventions or associations of churches and non-private foundations with gross receipts not more than \$5,000 are excepted from the application requirement. IRC § 508(c)(1).

<sup>6</sup> Rev. Proc. 2007-52, 2007-30 I.R.B. 226.

<sup>7</sup> IRS, Form 1023, *Application for Recognition of Exemption under Section 501(c)(3) of the Internal Revenue Code* (June 2006).

<sup>8</sup> IRS, *Instructions for Form 1023* (June 2006).

<sup>9</sup> IRS, Publication 557, *Tax-Exempt Status for Your Organization* (Mar. 2005).

<sup>10</sup> See IRS, Form 1023, *Application for Recognition of Exemption under Section 501(c)(3) of the Internal Revenue Code* (June 2006); IRS, *Instructions for Form 1023* (June 2006).

<sup>11</sup> IRS, Form 1023, *Application for Recognition of Exemption under Section 501(c)(3) of the Internal Revenue Code*, Part XI (June 2006). If an applicant's gross receipts have not or will not exceed \$10,000 per year for a four-year period, the required user fee is \$300. See *id.*

<sup>12</sup> This estimate includes time spent recordkeeping; learning about the law or the form; preparing the form; and copying, assembling, and sending the form to the IRS. IRS, *Instructions for Form 1023* 24 (June 2006).

<sup>13</sup> IRS, *Instructions for Form 1023* 24 (June 2006).

<sup>14</sup> See Most Serious Problem, *Exempt Organization Outreach*, *supra*.

<sup>15</sup> See Treas. Reg. § 1.508-1(a)(2)(i); T.D. 8680, 1996-33 I.R.B. 5, 1996-2 C.B. 194 (June 27, 1996).

<sup>16</sup> IRS, *Deductibility of Contributions*, at <http://www.irs.gov/charities/charitable/article/0,,id=164249,00.html>.

Nonetheless, an organization faces various practical limitations during the period in which it has applied for but not yet obtained exempt status. Many donors, particularly grantmakers, are reluctant to give to an organization awaiting a determination letter.<sup>17</sup> The difficulty of raising funds while an exemption application is pending can prevent would-be EOs from providing much-needed services to the public. In addition, organizations cannot avail themselves of state tax benefits such as income, franchise, sales, and property tax exemptions until they receive federal exemption and thus must pay such taxes while they wait for an IRS determination.

### Current Exempt Organization Determination Process

Exemption applications are submitted to the Cincinnati Submission Processing Center (CSPC) in Covington, Kentucky, which processes the user fees and mails letters acknowledging receipt of the applications before forwarding the applications to the Exempt Organizations Determinations Processing Section in Cincinnati, Ohio for screening.<sup>18</sup> In an effort to speed up processing, the IRS began screening applications into three categories in the fall of 2006:

1. Applications that can be processed immediately based on the information submitted;
2. Applications that need minor additional information to be resolved; and
3. Applications that require substantial additional development.<sup>19</sup>

Within approximately 60 days of the application submission date, the IRS sends determination letters to organizations whose applications fall in the first category and requests additional information from those in the second category.<sup>20</sup> The remaining applications, approximately half the total,<sup>21</sup> are assigned to EO specialists.<sup>22</sup>

### Delays in Exemption Application Processing

The IRS's Tax Exempt and Government Entities (TE/GE) division acknowledges that a backlog of exemption applications developed over the past several years.<sup>23</sup> In November 2005, approximately 12,000 applications awaited assignment to agents for processing.<sup>24</sup>

<sup>17</sup> See Staff of Joint Committee on Taxation, 98<sup>th</sup> Cong., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 705 (Comm. Print 1984).

<sup>18</sup> TE/GE response to TAS research request (June 20, 2007).

<sup>19</sup> See IRS, *EO Update*, Issue 2006-18 (Oct. 26, 2006); IRS, *Where Is My Exemption Application?*, at <http://www.irs.gov/charities/article/0,,id=156733,00.html>.

<sup>20</sup> IRS, *Where Is My Exemption Application?*, at <http://www.irs.gov/charities/article/0,,id=156733,00.html>.

<sup>21</sup> See TE/GE response to TAS research request (Sept. 28, 2007); IRS, *Tax Exempt and Government Entities Business Performance Review 22* (May 9, 2007).

<sup>22</sup> IRS, *Where Is My Exemption Application?*, at <http://www.irs.gov/charities/article/0,,id=156733,00.html>.

<sup>23</sup> See IRS, *FY 2007 Exempt Organizations Implementing Guidelines 7* (Nov. 7, 2006).

<sup>24</sup> *Id.*

In fiscal year (FY) 2006, TE/GE implemented a number of measures to reduce the inventory of unassigned cases. In addition to the three-tier triage process described above, the division introduced agent specialization into the determination process, whereby agents with specialized training work particular types of determination cases.<sup>25</sup> To further assist agents and decrease the number of contacts with applicants and overall processing time, TE/GE developed guide sheets and reference materials.<sup>26</sup> Finally, every two months since July 2006, TE/GE has shipped 1,000 to 1,500 of the oldest unassigned cases to a group of experienced IRS tax law specialists in Washington, D.C.<sup>27</sup>

The application backlog has decreased from 12,000 in 2005<sup>28</sup> to just over 5,400 as of March 31, 2007.<sup>29</sup> It is unclear, however, that the backlog will not again swell when TE/GE stops sending aged cases to the Washington, D.C. specialists, as the division plans to do as of September 30, 2008.<sup>30</sup> Like the size of the backlog, average cycle days (the number of days from submission to final action on an application for both open and closed cases) have declined from 134 days at the start of FY 2007 to 124 days as of August 24, 2007.<sup>31</sup>

Yet, looking at the reduced backlog and shorter cycle time in isolation creates an inaccurate picture of the length of the determination process. The FY 2007 cycle time decrease was largely driven by a decline in applications received.<sup>32</sup> Exemption application receipts for the first two quarters of FY 2007 decreased by more than 4,000, a nine percent drop from the same period in FY 2006.<sup>33</sup> This decrease in receipts is due in part to the rejection of applications submitted on obsolete forms or with incorrect user fees.<sup>34</sup>

Another factor in the reduced cycle time was the resolution of many applications (over 2,800 during the first half of FY 2007) by the Washington D.C. specialists.<sup>35</sup> Like the decrease in receipts, the closure of cases by the Washington, D.C. office is only temporary because of TE/GE's plans to discontinue that practice, as discussed above.

TAS cases involving EO determinations indicate that application processing delays remain a serious problem. The number of related TAS cases has increased by 78 percent from

<sup>25</sup> See IRS, *FY 2007 Exempt Organizations Implementing Guidelines 7* (Nov. 7, 2006).

<sup>26</sup> *Id.*

<sup>27</sup> Information received from TE/GE (Nov. 6, 2007).

<sup>28</sup> IRS, *FY 2007 Exempt Organizations Implementing Guidelines 7* (Nov. 7, 2006).

<sup>29</sup> IRS, *Tax Exempt and Government Entities Business Performance Review 23* (May 9, 2007).

<sup>30</sup> Information received from TE/GE (Nov. 6, 2007).

<sup>31</sup> TE/GE response to TAS research request (Sept. 28, 2007).

<sup>32</sup> IRS, *Tax Exempt and Government Entities Business Performance Review 23* (May 9, 2007).

<sup>33</sup> *Id.*

<sup>34</sup> See IRS, *Tax Exempt and Government Entities Business Performance Review 23* (May 9, 2007). Approximately 1,517 applications were rejected in FY 2007 because they were submitted on an old form or without the full user fee and the organization failed to respond to the IRS's request to submit the new form or additional fee. TE/GE response to TAS research request (Sept. 28, 2007).

<sup>35</sup> IRS, *Tax Exempt and Government Entities Business Performance Review 23* (May 9, 2007).



FY 2005 to FY 2007.<sup>36</sup> TAS received 527 such cases in FY 2005, 867 in FY 2006, and 939 in FY 2007. Notably, TAS receipts increased by more than eight percent from FY 2006 to FY 2007 despite a nine percent decrease in application receipts in the first half of FY 2007<sup>37</sup> and TE/GE's introduction of corrective measures in late FY 2006 and early FY 2007.

Even though TE/GE has experienced a sizeable drop in inventory and has temporarily utilized additional experienced agents, many organizations had to wait much longer than 125 days (TE/GE's FY 2007 average processing time target)<sup>38</sup> to receive determination letters. Specifically, in the ten-month period from October 2006 through July 2007, more than 9,700, or roughly 24 percent, of the nearly 41,000 IRC § 501(c)(3) applicants did not receive the letter within 180 days of submitting their applications.<sup>39</sup>

As of September 2007, the oldest open application dated back to May 12, 2003 (the application involved a proposed adverse determination being reviewed by the Office of Appeals).<sup>40</sup> The next oldest open application was submitted on December 6, 2004, and has been assigned to an agent since June 14, 2005.<sup>41</sup> The oldest unassigned application as of September 2007 was submitted eight months earlier, on January 18, 2007. Moreover, a total of 44 applications filed within one month of January 18, 2007, also awaited assignment as of September 2007.<sup>42</sup>

A "significant percentage" of organizations with complex applications waited more than 270 days for determination letters.<sup>43</sup> Of the applications open in August 2007, 1,452 had been submitted more than 270 days prior.<sup>44</sup> Beginning in the second quarter of FY 2006, a trend toward taking more than 270 days to make even the first contact with an applicant emerged and continued for the rest of that fiscal year. These "lengthy gaps between the control date and the assignment of cases, and the failure to make the initial contact with the customer within a reasonable period" have led to declines in scores on TE/GE's own quality measures.<sup>45</sup>

<sup>36</sup> TAS case receipts were extracted from the Taxpayer Advocate Management Information System (TAMIS) for cases received in FYs 2005, 2006, and 2007 with Primary Issue Code 460.

<sup>37</sup> See IRS, *Tax Exempt and Government Entities Business Performance Review 22* (May 9, 2007).

<sup>38</sup> *Id.*

<sup>39</sup> TE/GE response to TAS research request, Attachment F (Sept. 14, 2007).

<sup>40</sup> TE/GE response to TAS research request (Oct. 15, 2007).

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> Manager, EO Determinations Quality Assurance, *Memorandum for Manager, EO Determinations and Area Managers, EO Determinations, TEQMS Report for FY 2007, Quarter 1* (Apr. 5, 2007). A prospective IRC § 501(c)(3) is authorized by IRC § 7428 to file a declaratory judgment action in the Tax Court, Court of Federal Claims, or the U.S. district court for the District of Columbia if the IRS fails to issue a determination within 270 days of the date the exemption application was submitted.

<sup>44</sup> TE/GE response to TAS research request (Sept. 28, 2007).

<sup>45</sup> Manager, EO Determinations Quality Assurance, *Memorandum for Manager, EO Determinations and Area Managers, EO Determinations, TEQMS Report for FY 2007, Quarter 1* (Apr. 5, 2007).

Understaffing plays a major role in exemption application processing delays. TE/GE stated in response to the National Taxpayer Advocate's 2004 Annual Report to Congress that it planned to hire an additional 20 employees to screen applications.<sup>46</sup> EO Determinations had 191 revenue agents as of the end of FY 2004.<sup>47</sup> At the close of FY 2007, there were 187 revenue agents working EO determinations.<sup>48</sup> There were 292 employees in all of EO Determinations at the end of FY 2004, but the number decreased to 276 by the end of FY 2007.<sup>49</sup> Not only did the promised additional hires not come to fruition, the number of EO Determination employees has fallen from 2004 levels.

### Inadequate Communication About Application Status

From the perspective of prospective exempt organizations, the delays in exemption application processing are compounded by a lack of information from the IRS. The IRS sends an acknowledgement letter, Notice 3367, to applicants after CSPC completes the initial processing of their applications, and confirms receipt of the application. Organizations are told that applications fall into three categories, but are given no indication about where their own applications have been placed and no processing timeframe for applications in group 3.<sup>50</sup> Applicants therefore have no way to determine how long the application process will take and thus cannot accurately plan for activities, gauge when to apply for grants, or know when to follow up with the IRS.

Later in FY 2008, the IRS will begin sending all organizations whose applications were found to require substantial additional development an interim letter, CP 5104.<sup>51</sup> CP 5104 informs applicants that the IRS could not decide on their applications after initial screening, but, like Notice 3367, it provides no processing timeframe.

Both the initial acknowledgement and the interim letters direct applicants to the IRS's website for information.<sup>52</sup> The link notifies visitors that applications received as of a certain month are currently being assigned. If an organization applied in or after the month indicated, it is essentially told "don't call us, we'll call you." Specifically, the website directs organizations to, "continue to check this web page for updates and wait for us to contact you. **There is no need to call** [emphasis in original]."<sup>53</sup> Applicants who applied prior to the

<sup>46</sup> National Taxpayer Advocate 2004 Annual Report to Congress 209.

<sup>47</sup> *Id.* at 203.

<sup>48</sup> Information received from TE/GE (Nov. 6, 2007).

<sup>49</sup> *Id.*

<sup>50</sup> Notice 3367 states, "Your application was entered into our computer system and has been sent for initial review. Applications are initially separated into three groups: (1) those that can be processed immediately based on information submitted, (2) those that need minor additional information to be resolved, and (3) those that require additional development... If your application falls in the first or second group, you will receive your exemption letter or a request for additional information, via phone, fax, or letter, within approximately 60 days of the date the application was submitted... If your application falls within the third group, you will be contacted when your application has been assigned to an Exempt Organizations specialist."

<sup>51</sup> TE/GE response to TAS research request (Oct. 15, 2007).

<sup>52</sup> Notice 3367 states, "Unfortunately, we are experiencing delays in working applications that require further development. Please click on the Where Is My Exemption Application? link found at [www.irs.gov/eo](http://www.irs.gov/eo) for the dates of cases currently being assigned."

<sup>53</sup> IRS, *Where Is My Exemption Application?* at <http://www.irs.gov/charities/article/0,,id=156733,00.html>.

listed month are advised that they may want to contact TE/GE Customer Account Services on its toll-free telephone line.<sup>54</sup>

### Expedited Requests

The IRS could alleviate the burden of processing delays for organizations most in need of determination letters by expediting the processing of their applications. The IRS generally processes applications in the order received, but moves expedited cases ahead of others.<sup>55</sup> If the IRS grants expedited treatment to an unassigned application, it will be assigned within 24 to 48 hours to an agent who must process expedited applications before any others previously assigned.<sup>56</sup>

The decision to grant a request for expedited treatment is within the IRS's discretion, which will grant such treatment only for a "compelling" reason.<sup>57</sup> The Internal Revenue Manual (IRM) provides that expedited processing will generally be granted in the following circumstances:

1. 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 operate;
2. The purpose of the newly created organization is to provide disaster relief to victims of emergencies such as flood and hurricane;
3. IRS errors have caused undue delays in issuing a determination letter; and
4. In any other situation where the EO Determinations Manager or delegate determines that expedited service is warranted.<sup>58</sup>

Despite the IRS's authority to grant expedited processing wherever it deems warranted, it denies 82 percent of such requests.<sup>59</sup>

### New IRS Initiatives to Improve the Exemption Application Process

During FY 2006, TE/GE completed a prototype of the Cyber Assistant, a web-based tool that guides applicants through the completion of Form 1023.<sup>60</sup> The IRS is searching for partners to pilot, test, market, and host Cyber Assistant.<sup>61</sup> It is unclear when the tool will be widely available or how much of an impact it will have on the filing burden and processing time.

<sup>54</sup> *Id.*

<sup>55</sup> Rev. Proc. 2007-4, 2007-1 I.R.B. 118.

<sup>56</sup> TE/GE response to TAS research request (June 20, 2007).

<sup>57</sup> Rev. Proc. 2007-4, 2007-1 I.R.B. 118.

<sup>58</sup> IRM 7.21.3.4.1 (Jan. 1, 2003); IRM 3.45.1.23 (Jan. 1, 2005).

<sup>59</sup> IRS, *Form 1023: Expediting Application Processing*, at <http://www.irs.gov/charities/article/0,,id=139805,00.html> (last visited on Oct. 26, 2007).

<sup>60</sup> IRS, *FY 2007 Exempt Organizations Implementing Guidelines* 8 (Nov. 7, 2006).

<sup>61</sup> *Id.*

TE/GE is replacing the system it currently uses to process and track applications for tax-exempt status with a new system, the Tax Exempt Determination System (TEDS). Migration to TEDS is scheduled for completion some time in FY 2008.<sup>62</sup> TE/GE predicts TEDS will decrease processing time because files will be available electronically and will no longer have to be mailed within TE/GE.<sup>63</sup> However, the Treasury Inspector General for Tax Administration (TIGTA) found an early release of TEDS did not deliver all of the promised benefits and exceeded cost estimates.<sup>64</sup>

## IRS Comments

### Reducing Delays in Exemption Application Processing

The IRS has achieved a 55 percent reduction in the backlog of unassigned applications for exempt status, and intends to further reduce this backlog during this fiscal year. The dramatic reduction is the result of a focused, multi-faceted effort that will continue until inventory is reduced to a sustainable level.

The IRS sees no evidence on which the National Taxpayer Advocate could conclude that the backlog will swell again once we have eliminated it. The National Taxpayer Advocate is correct that part of our success to date is due to a small (two percent) decline in the number of applications received in FY 2007. However, the IRS processing center in Cincinnati is now processing as many applications as it is receiving. At the same time, the use of specialists in EO's Washington, D.C. headquarters is steadily eliminating the backlog. The IRS decided to continue sending applications to EO headquarters through FY 2008. Once the current backlog is eliminated, we will continue to monitor inventory to ensure that the backlog does not re-emerge and will take steps as needed to prevent that. Our success in reducing the average age of over-all inventory from approximately 130 days at the end of FY 2006 to 97 days at the end of FY 2007 is additional evidence that we will continue to be successful.

### Improving Communication about Applications

The IRS continues to look for ways to better inform applicants about the status of their applications. For example, in September 2006, we amended our acknowledgment letters to let applicants know that they can check the status of their application on line. Applicants are directed to the IRS website where they can obtain the receipt date of the applications the IRS is currently reviewing. The website also explains the exemption application review process in plain language and provides a flowchart that illustrates the process. The website includes a discussion of the timeframes that are typically required to complete each of the three classes of cases.

<sup>62</sup> Information received from TE/GE (Nov. 6, 2007).

<sup>63</sup> TE/GE response to TAS research request (Sept. 28, 2007).

<sup>64</sup> Treasury Inspector General for Tax Administration, Ref. No. 2006-10-174, *The Tax Exempt Determination System Release 1 Delivered Only a Small Portion of the Expected Benefits and Significantly Exceeded Cost Estimates* (Sept. 2006).

Each application differs depending on the information the applicant provides and the type of activity the proposed organization intends to engage in. Some applications need less review and development and some require more. To further improve communication with applicants, the IRS has begun a limited use of the new CP 5104 notification, which tells applicants in appropriate cases that, as a result of initial screening, their case has been selected for full development. This notification, in conjunction with the website information, provides a more complete picture of where an application is in the review process. We anticipate full implementation of this notice in early 2008.

An application that arrives complete at the IRS results in a faster review and processing time. Toward that end, the IRS has also posted on its website determination guidesheets for various types of cases, including those that are more complex and will require in-depth review. These guidesheets educate applicants about the information needed to process their applications. The guidelines supplement the wide array of information and advice the IRS makes available to applicants through publications or on the web.

### **Ensuring Fairness of Treatment**

Out of fairness to all, the IRS policy is to process applications in the order in which they arrive. The IRS recognizes that, in a limited number of cases, an applicant may have a compelling reason for us to advance his or her application ahead of other applicants, and in such cases we do expedite the case. The IRS does not deny such requests arbitrarily. The National Taxpayer Advocate has noted the criteria that we use to evaluate these requests; requests that are rejected do not present these compelling reasons.

### **New IRS Initiatives to Improve the Exemption Application Process**

The IRS continuously looks for ways to improve the efficiency of the application process. The National Taxpayer Advocate refers to two of our initiatives in her report. The first of these is Cyber Assistant, which the IRS plans to roll out this year. Cyber Assistant is an electronic guide that will lead applicants for exempt status step-by-step through the Form 1023 application for exemption. It is similar in concept to tax preparation software that millions of taxpayers use to prepare their Forms 1040. Just as such software is a boon to individual taxpayers, the IRS believes Cyber Assistant will make the preparation of an application for exempt status easier and more accurate.

The second initiative is the Tax Exempt Determinations System (TEDS). This is a system that IRS employees will begin to use this year to manage and work determination applications. Among other things, it incorporates streamlined processes and eliminates the need to ship files. The IRS expects TEDS to contribute to a shortened cycle time for completing the review applications. The IRS plans to complete migration to TEDS by the end of FY 2008.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate acknowledges the IRS's continuing efforts to improve the determination letter process and recognizes that progress has been made on certain measures. Nonetheless, serious problems persist.

### *Delays in Exemption Application Processing*

The application backlog has, as the IRS notes in its response, decreased by 55 percent. While the reduction in applications awaiting assignment from 12,000 as of November 2005,<sup>65</sup> to just over 5,400 as of March 31, 2007,<sup>66</sup> is significant, it took nearly a year and a half to achieve. Moreover, the IRS's multi-year effort has only reduced the backlog to a level on par with that of the three fiscal years preceding the spike of FY 2004.<sup>67</sup> Such a level proved unsustainable in the past, and the National Taxpayer Advocate lacks confidence that, absent further improvements to the determinations process, it will be maintained long-term.

The IRS's response, with its focus on the reductions in the backlog of unassigned applications and average cycle time, ignores other evidence of a continuing problem. In the 10-month period from October 2006 through July 2007, more than 24 percent of IRC § 501(c)(3) applicants waited more than 180 days for a determination letter.<sup>68</sup> Of the applications open in August 2007, 1,452 were more than 270 days old.<sup>69</sup> TAS cases involving determination letter delays increased by more than eight percent from FY 2006 to FY 2007.<sup>70</sup>

### *Inadequate Communication about Application Status*

The National Taxpayer Advocate is pleased that the IRS plans to begin sending an interim letter to all organizations whose applications fall in the "require additional development" category. Unfortunately, while the initial application acknowledgement letter and the "Where Is My Exemption Application?" link on the IRS website state that a determination letter or a request for additional information will be sent to applicants falling within the first two application categories within approximately 60 days of the application date, the acknowledgment and interim letters and the IRS website provide no such timeframe for the third category of applications. The National Taxpayer Advocate recommends that the application acknowledgement letter, interim letter, and "Where Is My Exemption Application?" link and application process flowchart on the IRS website be revised to give

<sup>65</sup> IRS, *FY 2007 Exempt Organizations Implementing Guidelines 7* (Nov. 7, 2006).

<sup>66</sup> IRS, *Tax Exempt and Government Entities Business Performance Review 23* (May 9, 2007).

<sup>67</sup> Total unassigned applications were 6,768 as of September 29, 2001, 5,477 as of September 27, 2002, and 6,226 as of September 26, 2003. National Taxpayer Advocate 2004 Annual Report to Congress 197.

<sup>68</sup> TE/GE response to TAS research request, Attachment F (Sept. 14, 2007).

<sup>69</sup> TE/GE response to TAS research request (Sept. 28, 2007).

<sup>70</sup> TAS case receipts were extracted from the Taxpayer Advocate Management Information System (TAMIS) for cases received in FYs 2005, 2006, and 2007 with Primary Issue Code 460.

applicants a general timeframe for processing applications that need additional development. Moreover, the National Taxpayer Advocate believes the IRS should require agents to establish regular “next contact dates” and “follow up dates” to increase timeliness of actions on the part of the IRS and the taxpayer, and to better manage taxpayer expectations. A letter providing a revised, organization-specific processing timeframe should also be sent in all cases that remain open for more than 120 days.

### *Expedited Requests*

The National Taxpayer Advocate understands the IRS’s position that expedited treatment must be limited to compelling cases to ensure that all applicants are treated equally. The National Taxpayer Advocate is concerned, however, that the ongoing application processing delays have a disproportionately negative impact on small organizations and thus recommends that the IRS consider granting expedited treatment to such organizations where an adverse impact other than the loss of a particular pending grant can be demonstrated. The National Taxpayer Advocate invites TE/GE to work with her to identify these situations and draft appropriate procedures.

In response to our inquiries, the IRS stated that it has “no way of knowing the percentage of expedite requests that are approved or denied” and that the 82 percent denial rate cited on the IRS website was thus inaccurate and has since been removed.<sup>71</sup> The National Taxpayer Advocate believes the IRS cannot gauge whether expedited treatment is operating as intended in the absence of such data, and therefore recommends that the IRS develop a way to track the number of applicants requesting and granted such treatment and the reasons those requests are granted or denied.

### *New IRS Initiatives to Improve the Exemption Application Process*

The IRS indicates in its response that it expects its new Tax Exempt Determination System (TEDS) to decrease application cycle time. Yet, a recent report on TEDS Release 2 by the Treasury Inspector General for Tax Administration (TIGTA) found that schedule delays and deletion of some system capabilities resulted in TEDS delivering less than half of the expected benefits.<sup>72</sup> Any promised improvements in application processing based solely on this system are therefore questionable. Alternative interim strategies to improve the determinations process remain critically important.

<sup>71</sup> TE/GE response to TAS research request (Nov. 21, 2007).

<sup>72</sup> Treasury Inspector General for Tax Administration, Ref. No. 2008-10-025, *Management Oversight Improved, but Expected Benefits and Capabilities for the Tax Exempt Determination System Release 2 Were Not Delivered* 6 (Dec. 2007).



## Recommendations

The National Taxpayer Advocate encourages the IRS to continue to build on its current initiatives but also recommends that the IRS:

- Implement procedures for upper-level review of cases as soon as they surpass 120 days, and at regular intervals thereafter, to ensure that agents are properly working cases and following up with applicants in a timely manner.
- Include in managers' quality ratings a measure of their completion of the 120-day and other regular case reviews.
- Analyze the 120-day review information to determine why delays occur and take the necessary action to avoid future delays.
- Require agents to contact the organizations whose applications are assigned to them to establish regular "next contact dates" and "follow up dates" throughout the application process. Utilize "next contact dates" and "follow up dates" to increase timeliness and quality of taxpayer responses and IRS actions.
- For applications where processing has exceeded 120 days, provide applicants a letter estimating when they may expect to receive a determination and the reason why it is delayed.
- Revise the application acknowledgement letter (Notice 3367), the interim letter (CP 5104), and the "Where Is My Exemption Application?" link and application process flowchart on the IRS website to provide a timeframe for the issuance of determination letters in cases that require additional development.
- Track the numbers of expedited requests received, granted, denied, and not acted upon; the reasons they are granted and the reasons they are denied; and use the results to evaluate and improve the process, and educate applicants.
- Evaluate staffing needs and maintain a staffing level commensurate with application receipts.
- Conduct training to develop multiple specialized agents per specialty area.
- Utilize the TE/GE Advisory Committee as a resource to measure customer needs and preferences to address concerns of EOs.

MSP  
#15**EITC Examinations and the Impact of Taxpayer Representation****Responsible Officials**

Richard J. Morgante, Commissioner, Wage and Investment Division  
Kathy Petronchak, Commissioner, Small Business/Self-Employed Division

**Definition of Problem**

Many taxpayers have difficulty navigating the IRS examination process, particularly in the area of the Earned Income Tax Credit (EITC).<sup>1</sup> Anecdotal evidence from Low Income Taxpayer Clinics (LITCs) and other taxpayer representatives suggests many taxpayers who are audited for the EITC may be entitled to the credit, but are simply failing the IRS examination process.<sup>2</sup> The presence of representation may affect the outcome of these exams. In an effort to understand more about this problem, the National Taxpayer Advocate requested a study to determine whether the presence of a representative, such as an accountant, Enrolled Agent, or attorney, impacts the outcome of EITC audits.<sup>3</sup> The study's findings indicate that taxpayers retain more of their EITC if they have representation during the examination.<sup>4</sup>

These results suggest the IRS examination strategy is flawed. Changes to the existing IRS exam strategy – including simplifying the exam process and promoting available taxpayer services – are necessary to ensure that procedural barriers do not prevent taxpayers from receiving the EITC to which they are entitled.

<sup>1</sup> *Earned Income Tax Credit (EITC) Audit Reconsideration Study*, National Taxpayer Advocate 2004 Report to Congress vol. 2; Taxpayer Advocate Service, *Challenges for Taxpayers Claiming the Earned Income Tax Credit (EITC), From Interviews with Low Income Tax Clinics* (Sept. 2005). See also *Correspondence Examination*, National Taxpayer Advocate 2006 Annual Report to Congress at 289; *Limited English Proficient (LEP) Taxpayers: Language and Cultural Barriers to Tax Compliance*, National Taxpayer Advocate 2006 Annual Report to Congress at 333; *Taxpayer "No Response" Rates*, National Taxpayer Advocate 2006 Annual Report to Congress at 355; *EITC Exam Issues*, National Taxpayer Advocate 2005 Annual Report to Congress at 94; *Earned Income Tax Credit (EITC) Compliance Strategy*, National Taxpayer Advocate 2003 Annual Report to Congress at 26; *Combination Letter*, National Taxpayer Advocate 2003 Annual Report to Congress at 87; *EITC Eligibility Determination Can Be Made Less Burdensome*, National Taxpayer Advocate 2002 Annual Report to Congress at 47; *Procedures for Examining EITC Claims Cause Hardship and Infringe on Appeal Rights*, National Taxpayer Advocate 2002 Annual Report to Congress at 55; *Lack of Response During EITC Exams*, National Taxpayer Advocate 2002 Annual Report to Congress at 64; *The Length of EITC Audits Contributes to Taxpayer Concerns*, National Taxpayer Advocate 2002 Annual Report to Congress at 75; *Language and Cultural Barriers Impact Taxpayer Compliance*, National Taxpayer Advocate 2002 Annual Report to Congress at 88.

<sup>2</sup> Taxpayer Advocate Service, *Challenges for Taxpayers Claiming the Earned Income Tax Credit (EITC), From Interviews with Low Income Taxpayer Clinics* (Sept. 2005).

<sup>3</sup> See *Impact of Taxpayer Representation on the Outcome of Earned Income Tax Credit Audits*, *infra* vol. 2.

<sup>4</sup> *Id.* at X.

## Analysis of Problem

### Background

EITC audits represent approximately 40 percent of all IRS individual taxpayer audits.<sup>5</sup> While auditing tax returns plays an important role in ensuring compliance, evidence suggests that taxpayers experience barriers in communicating with the IRS and providing the necessary documentation to prove they are eligible for the EITC.<sup>6</sup>

### *EITC Audit Reconsideration Study*

The TAS EITC Audit Reconsideration Study, released in December 2004, focused on identifying ways to improve the accuracy and effectiveness of EITC audit reconsiderations and the overall EITC correspondence exam process, including minimizing burden to taxpayers.<sup>7</sup> In the cases examined, taxpayers cited documentation difficulties as a reason for the audit reconsideration in 45 percent of the cases and communication challenges as a cause in 42 percent of the cases.<sup>8</sup>

The study empirically demonstrates that 43 percent of taxpayers who sought reconsideration of correspondence examinations in which the IRS disallowed the EITC in whole or in part received additional EITC as a result of the audit reconsideration.<sup>9</sup> Where the taxpayer received additional EITC, he or she received, on average, 96 percent of the credit claimed on the original return.<sup>10</sup> Moreover, when TAS employees initiated contact with taxpayers by phone instead of relying solely on correspondence, the likelihood of a taxpayer receiving additional EITC increased significantly in direct proportion to the number of phone calls made.<sup>11</sup>

The EITC Audit Reconsideration Study ultimately found that taxpayers who do not respond to notices are typically no less entitled to prevail in an audit reconsideration than those who respond timely. The barriers taxpayers faced in meeting the documentation requests can be found throughout the exam process and are not limited to EITC audit reconsiderations.

<sup>5</sup> IRS, *FY 2005 Data Book Table 10* (42.9 percent).

<sup>6</sup> See *Impact of Taxpayer Representation on the Outcome of Earned Income Credit Audits*, *infra* vol. 2; Taxpayer Advocate Service, *Challenges for Taxpayers Claiming the Earned Income Tax Credit (EITC)*, *From Interviews with Low Income Tax Clinics* (Sept. 2005); *Earned Income Tax Credit (EITC) Audit Reconsideration Study*, National Taxpayer Advocate 2004 Report to Congress vol. 2.

<sup>7</sup> For a detailed discussion of the study and its results, see *Earned Income Tax Credit (EITC) Audit Reconsideration Study*, National Taxpayer Advocate 2004 Report to Congress vol. 2. Audit reconsideration is an IRS process available to a taxpayer who meets certain eligibility criteria when the taxpayer disagrees with an IRS assessment made during an audit or disagrees with an Automated Substitute for Return (ASFR) the IRS created when the taxpayer did not file his or her own return.

<sup>8</sup> *Earned Income Tax Credit (EITC) Audit Reconsideration Study*, National Taxpayer Advocate 2004 Report to Congress vol. 2, at 19.

<sup>9</sup> *Id.* at 29. For the EITC Audit Reconsideration Study, the team reviewed a random sample of more than 900 EITC audit reconsideration cases closed between July 1, 2002 and January 31, 2003. Ultimately, 679 cases (340 Examination and 339 TAS) had mostly complete data and were analyzed in detail for this study. Analyses segmented data by Examination and TAS involvement, in addition to summarizing the total dataset. See *Id.* at 9. The sample used in the study was statistically representative of the closed EITC audit reconsideration cases. *Id.* at 15.

<sup>10</sup> See *Earned Income Tax Credit (EITC) Audit Reconsideration Study*, National Taxpayer Advocate 2004 Report to Congress vol. 2, at 29.

<sup>11</sup> *Id.* at 35-37.

### *EITC Audit Barriers Study*

TAS also worked with the EITC Program Office and the Wage and Investment (W&I) division's Research organization to identify the most significant barriers taxpayers encounter during the EITC correspondence examination process and to identify areas of improvement.<sup>12</sup> The first phase of the research consisted of targeted interviews with LITC<sup>13</sup> representatives who have assisted taxpayers undergoing EITC correspondence exams.<sup>14</sup>

The participants suggested that the IRS's reliance on correspondence during the exam causes problems for many EITC taxpayers who sometimes cannot understand the IRS letters they receive.<sup>15</sup> Also, in part because of language barriers and trust issues, some low income EITC taxpayers are more comfortable visiting an IRS walk-in site than calling or writing to resolve a problem.<sup>16</sup>

The team used the results of the interviews to design a survey, which was sent to a representative sample of taxpayers who were audited for EITC for tax year (TY) 2004.<sup>17</sup> The results of the survey shed additional light on the difficulties IRS exam procedures cause for taxpayers. When asked if, upon receiving the letter from the IRS regarding the audit of their tax return, it was clear that their tax return was being audited, approximately 26 percent of respondents said it was not clear.<sup>18</sup> When asked about the overall content of the letter:

- Over 42 percent of respondents did not understand some of the IRS words and terms in the letter;
- Almost 40 percent of respondents did not understand what the IRS was questioning on their tax returns;
- Just over 16 percent of respondents were scared by the tone of the letter;
- Sixteen percent found the instructions hard to follow; and
- Over 35 percent of respondents indicated they did not understand what they needed to do in response to the letter.<sup>19</sup>

<sup>12</sup> Wage and Investment, *EITC Audit Barriers Survey*, Research Project 6-05-12-2-048E (Oct. 2007); Taxpayer Advocate Service, *Challenges for Taxpayers Claiming the Earned Income Tax Credit (EITC), From Interviews with Low Income Tax Clinics* (Sept. 2005).

<sup>13</sup> The LITC Program is a grant program under IRC § 7526 in which qualified organizations receive matching federal grants to represent low income taxpayers in controversies before the IRS or provide tax outreach and education to English as a second language (ESL) taxpayers.

<sup>14</sup> Taxpayer Advocate Service, *Challenges for Taxpayers Claiming the Earned Income Tax Credit (EITC), From Interviews with Low Income Tax Clinics* (Sept. 2005). For this study, eight LITC attorneys were interviewed about barriers EITC taxpayers face because of an examination of their tax return. The specific LITC sites were selected based on the number of EITC filers in the area, geographic location, and the proximity of an LITC.

<sup>15</sup> Taxpayer Advocate Service, *Challenges for Taxpayers Claiming the Earned Income Tax Credit (EITC), From Interviews with Low Income Tax Clinics* (Sept. 2005).

<sup>16</sup> *Id.* Practitioners explained that some like to look someone in the eyes to gauge whether to trust someone or how much trust to place in the answer provided.

<sup>17</sup> Wage and Investment, *EITC Audit Barriers Survey*, Research Project 6-05-12-2-048E at 1 (Oct. 2007).

<sup>18</sup> *Id.* at 6.

<sup>19</sup> *Id.* at 7.

Many taxpayers not only had difficulty understanding the IRS's letters regarding their examinations but also experienced problems obtaining the documents the IRS requested. When asked about problems in obtaining documents:

- Sixteen percent of respondents did not keep records;
- Approximately 12 percent did not know what documents were needed;
- Approximately 10 percent did not know where to get the documents they needed;
- More than 20 percent of respondents had to take time off work to obtain needed documents;
- Approximately 10 percent of respondents had to pay for documents; and
- Over 17 percent could not find all of the documents they needed.<sup>20</sup>

Although the above research is limited to EITC taxpayers, many low income taxpayers likely face similar barriers when trying to demonstrate their eligibility for related benefits<sup>21</sup> such as Head of Household filing status,<sup>22</sup> the dependency exemption,<sup>23</sup> and the Child Tax Credit.<sup>24</sup> These barriers may prevent taxpayers from proving their eligibility for certain tax benefits and cause incorrect examination results.

### Impact of Taxpayer Representation on the Outcome of EITC Audits

With increasing amounts of research suggesting that taxpayers face barriers in communicating with the IRS and demonstrating eligibility for the EITC, the National Taxpayer Advocate requested a study to determine whether the presence of a representative impacted the outcome of an IRS examination.<sup>25</sup> The study broke down the more than 400,000 tax year 2004 returns examined for EITC issues between represented and unrepresented taxpayers.<sup>26</sup> Only 7,688 taxpayers – or 1.8 percent of the returns – were represented during their original audits.<sup>27</sup>

<sup>20</sup> Wage and Investment, *EITC Audit Barriers Survey*, Research Project 6-05-12-2-048E at 14 (Oct. 2007).

<sup>21</sup> EITC, Head of Household filing status, dependency exemption and Child Tax Credit are considered “related issues” because eligibility is built, in part, on the uniform definition of a child (UDOC). UDOC, adopted in 2004, introduced a uniform definition of qualifying child that determines whether someone is a qualifying child for purposes of the family status provisions of the Code. The family status provisions of the Code are: EITC; Head of Household filing status; dependency exemption; Child Tax Credit; and Child and dependent care credit. For more detailed information about the family status provisions, see Most Litigated Issues, *Family Status Issues Under §§ 2, 21, 24, 32 and 151, infra*.

<sup>22</sup> Head of Household filing status under IRC § 2(b) entitles a taxpayers to a larger standard deduction and a more favorable tax rate than a single taxpayer or a married taxpayer filing separately.

<sup>23</sup> The dependency exemption under IRC § 151 allows a taxpayer to claim an exemption for each individual who qualifies as a dependent.

<sup>24</sup> The Child Tax Credit under IRC § 24 allows a taxpayer to claim a credit for each individual who qualifies.

<sup>25</sup> For the complete study, see *Impact of Taxpayer Representation on the Outcome of Earned Income Tax Credit Audits, infra* vol. 2. The Impact of Taxpayer Representation on the Outcome of Earned Income Tax Credit Audits study examined TY 2002 tax returns audited for EITC issues. Tax year 2002 returns were used to include the effect of certain significant tax law changes as well as to allow sufficient time for any case activities that occurred subsequent to the conclusion of the audit. *Id.* at 4.

<sup>26</sup> *Impact of Taxpayer Representation on the Outcome of Earned Income Tax Credit Audits, infra* vol. 2 at 4-5. The study looked only at closed cases. *Id.* at 4. For an explanation of the returns used for the study and a discussion of why some returns were removed from the study, see *Id.* at 4-6.

<sup>27</sup> *Impact of Taxpayer Representation on the Outcome of Earned Income Tax Credit Audits, infra* vol. 2 at 5.

The study showed *represented taxpayers are twice as likely to be found eligible for EITC and to have no changes made to their EITC as a result of the exam.*<sup>28</sup> Table 1.15.1 shows the breakdown of audit results for represented and unrepresented taxpayers.

**TABLE 1.15.1, EITC Retained and Disallowed During Audit<sup>29</sup>**

Percentage of Taxpayers with:	Not Represented	Represented
No change in EITC <sup>30</sup>	23.1%	41.5%
EITC reduced	4.3%	6.1%
EITC disallowed in full	72.6%	52.4%

The study also showed that represented taxpayers retain more of their EITC dollars than taxpayers who are not represented.<sup>31</sup> Taxpayers with representation retained, on average, 44.8 percent of their EITC dollars versus 25.3 percent of taxpayers without representation.<sup>32</sup> Represented taxpayers also retain more of their EITC in terms of total dollars than others without representation.<sup>33</sup> Represented and unrepresented taxpayers have similar before-audit EITC amounts,<sup>34</sup> but for an unrepresented taxpayer, the average EITC disallowed is \$587 higher.<sup>35</sup> Overall, represented taxpayers retain \$623 more in EITC than unrepresented taxpayers.<sup>36</sup> Figure 1.15.2 compares the amount of EITC before and after audit by type of representative.

<sup>28</sup> *Impact of Taxpayer Representation on the Outcome of Earned Income Tax Credit Audits, infra* vol. 2 at 7.

<sup>29</sup> *Id.* at 8.

<sup>30</sup> This “no change” rate includes taxpayers who actually received the EITC as a result of the audit. This includes 0.3 percent overall of not represented taxpayers and one percent overall of represented taxpayers.

<sup>31</sup> *Impact of Taxpayer Representation on the Outcome of Earned Income Tax Credit Audits, infra* vol. 2 at 10.

<sup>32</sup> *Id.* at X.

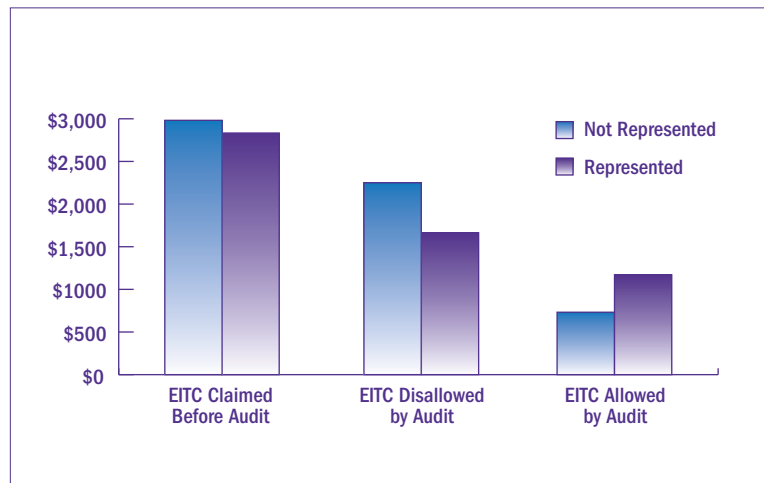
<sup>33</sup> *Id.* at 12.

<sup>34</sup> *Id.* at 11.

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

**FIGURE 1.15.2, Amount of EITC Before & After Audit  
For Represented and Non-Represented Taxpayers<sup>37</sup>**



The study also found fewer represented taxpayers owe additional tax at the conclusion of their audit.<sup>38</sup> The ultimate amount of tax owed is similar for unrepresented and represented taxpayers, but almost 60 percent of unrepresented taxpayers owe additional tax at the end of the audit, compared with approximately 23 percent of represented taxpayers.<sup>39</sup>

### The Current IRS Exam Strategy Needs Changes

The outcome of the TAS Impact of Representation study indicates that if the IRS wishes to arrive at the correct conclusion during EITC examinations, it must change its exam strategy. The vital role of representation in ensuring that taxpayers receive their full EITC suggests representatives may be able to help taxpayers overcome the barriers they face in responding to exams. Although the National Taxpayer Advocate recognizes that it is not feasible for the IRS to provide a representative for every taxpayer subject to examination, the IRS can still improve its existing exam policies. Simplifying the existing process and promoting available taxpayer services can help to ensure that the IRS is reaching the right result for all taxpayers.

### Simplify the Examination Process

The IRS needs to simplify its examination procedures to reflect the fact that many low income taxpayers – especially those trying to claim the EITC – cannot effectively navigate the traditional procedures. The TAS EITC Audit Reconsideration study is an example of the downstream effect of a taxpayer’s inability to navigate the IRS’s exam procedures.<sup>40</sup>

<sup>37</sup> *Impact of Taxpayer Representation on the Outcome of Earned Income Tax Credit Audits*, *infra* vol. 2 at 10.

<sup>38</sup> *Id.* at 13.

<sup>39</sup> *Id.*

<sup>40</sup> National Taxpayer Advocate 2004 Annual Report to Congress vol. 2.



In recent years, the IRS has made some improvements to its exam processes. In January 2006, W&I Correspondence Examination instituted Intelligent Call Management on its toll-free phones.<sup>41</sup> This service provides more immediate assistance to the taxpayer by providing a better level of service on unassigned cases and reduces the need for the taxpayer to call several times to seek assistance.

In May 2006, Correspondence Examination further expanded service by introducing new programming that allows extension-routed calls to roll over to the next available examiner if the assigned examiner is not available.<sup>42</sup> These initiatives contributed greatly to an increase in the level of service (LOS) provided to IRS Correspondence Examination customers. Through June 2007, the LOS is 82.5 percent, compared to 68.7 percent through June 2005, which represents a 20 percent increase in service.<sup>43</sup>

The National Taxpayer Advocate is also very pleased by the IRS's use of toll-free fax numbers available for taxpayers subject to an EITC exam. Because EITC claimants are by definition low income, the availability of toll-free fax numbers assists them in providing the IRS with documentation necessary to prove their EITC eligibility. The National Taxpayer Advocate commends the IRS's continued use and promotion of the EITC toll-free fax lines. Despite these improvements, the IRS can still take additional steps to ease the exam process for taxpayers.

### **Increase Communication With Taxpayers**

W&I Correspondence Examination's efforts to improve customer service centered on routing more taxpayer calls to live assistants. The result of this increased communication with taxpayers was a significant increase in the level of service provided. The TAS EITC Audit Reconsideration study also demonstrates the impact that direct contact with the taxpayer can have on the outcome of the taxpayer's case.<sup>44</sup>

The IRS needs to encourage more communication with taxpayers. The IRS should urge employees to call taxpayers to follow up on issues instead of simply relying on correspondence. Although examiners should not contact taxpayers in every situation, the IRS should train them to identify instances where calling a taxpayer will help resolve the case. Personal contact may help alleviate the confusion and fears associated with IRS requests and help taxpayers respond and receive the credit to which they are entitled.

### **Simplify Correspondence**

The IRS has also made some progress in simplifying the correspondence sent to taxpayers, namely by eliminating the combination letter for EITC exams; however, the IRS continues

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<sup>41</sup> IRS, *2006 Commissioner's Award Ceremony* at 19 (Dec. 2, 2006).

<sup>42</sup> *Id.*

<sup>43</sup> IRS, *FY07 W&I Compliance LOS Report – Exam* (week ending June 30, 2007). The National Taxpayer Advocate recognized W&I's efforts to provide improved customer service by awarding the team the National Taxpayer Advocate Award in 2006.

<sup>44</sup> National Taxpayer Advocate 2004 Annual Report to Congress vol. 2, at 35-37.

to use the combination letter for other discretionary work.<sup>45</sup> The EITC Audit Barriers Survey illustrates the difficulty some taxpayers face in understanding and responding to IRS correspondence.<sup>46</sup> As discussed above, the survey indicated that taxpayers often had difficulty understanding that their returns were being audited, what the IRS was questioning, or what they needed to do in response to the letter.<sup>47</sup> Many taxpayers did not understand some of the words and terms in the letters, were scared by their tone, or found the instructions hard to follow.<sup>48</sup>

The IRS must continue to simplify correspondence by eliminating boilerplate language and attempting to target each letter to a taxpayer's case and what he or she must do to resolve the issue. When requesting documentation, the IRS should provide details regarding the specific information the taxpayer needs to provide – as opposed to a general list that is not specific to the taxpayer's case. As discussed below, making information available in multiple languages is another way the IRS can improve correspondence and customer service.

#### **Address the Needs of ESL (English As a Second Language) and Disabled Taxpayers**

As part of its effort to simplify the overall exam process, the IRS must also do more to respond to the needs of ESL taxpayers. Language barriers create problems for many taxpayers who do not understand the IRS notices they receive.<sup>49</sup> The IRS could also allow taxpayers to specify or choose (possibly on their returns) the language in which they want to receive correspondence. While many notices are available in both English and Spanish, the IRS should make efforts to print them in other languages as well.

The IRS can also help overcome language barriers by working to meet the needs of ESL taxpayers the first time they call the IRS. Currently, TAS's toll-free ASKTAS1 phone line has a "hello message" in both English and Spanish. If a taxpayer speaks a language other than English or Spanish, a TAS employee will contact the Over-the-Phone Interpreter (OPI) Service to ensure the employee is able to communicate with the taxpayer. The IRS should ensure that similar services are available to taxpayers calling the toll-free phone lines, particularly on the toll-free EITC line. The W&I Exam toll-free phone lines do provide taxpayers with the option of continuing the discussion in Spanish; while this is a good start, the IRS should expand this service to other languages and increase promotion of the interpreter service. IRS employees should be trained to be sensitive to the needs of ESL taxpayers and ask taxpayers if they would like to use the interpreter service.

<sup>45</sup> National Taxpayer Advocate 2006 Annual Report to Congress at 296-97. In the context of the EITC, the combination letter is a single letter the IRS sent to taxpayers simultaneously denying the credit claimed on the tax return, asking the taxpayer to substantiate the EITC, and triggering the opportunity for the taxpayer to take his or her case to Appeals. For a detailed discussion of the combination letter, see National Taxpayer Advocate 2003 Annual Report to Congress at 87-98.

<sup>46</sup> For a detailed discussion of the EITC Audit Barriers study, see *supra* fn. 12-24 and accompanying text.

<sup>47</sup> See *supra* notes 18-19.

<sup>48</sup> See *Id.*

<sup>49</sup> See National Taxpayer Advocate 2006 Annual Report to Congress at 333, 355 (referring to Most Serious Problems on Limited English Proficient (LEP) taxpayers and No Response).

Disabled taxpayers face similar barriers.<sup>50</sup> Taxpayers can receive a notice in Braille if they call and request it from the IRS Alternative Media Center, but the IRS does not widely publicize this service and has no clear procedures for placing a hold on the taxpayer's account while waiting for the accommodating notice.<sup>51</sup> Nor is there any way for a taxpayer to ask the IRS to send all future correspondence in Braille. The IRS should consider placing language – in Braille – on envelopes indicating that they contain important IRS correspondence, and providing a telephone number to call for more information.

### **Adopt the Use of Affidavits**

Both the EITC Audit Reconsideration study and EITC Audit Barriers Survey highlight the problems taxpayers experience in meeting the IRS requirements for providing documentation to prove their EITC claims.<sup>52</sup> This difficulty can cause taxpayers to become discouraged and possibly ignore the IRS request entirely. As part of the 2004 EITC certification study, the IRS piloted the use of affidavits to allow taxpayers to prove they met the qualifying child residency requirement.<sup>53</sup> The study results indicate the affidavit is the most effective and accurate means of proving eligibility and taxpayers prefer using the affidavit to providing documents, records, or letters.<sup>54</sup>

Given the difficulties taxpayers face in obtaining needed documentation, the effectiveness of the affidavit, and taxpayers' willingness to use the new form, the IRS should expand use of the affidavit to all EITC examinations. This approach may also encourage increased participation by taxpayers if they know they are capable of sending the IRS the requested information. Based on the EITC certification study, the IRS should also test other methods of proof to determine which are most accurate and best suited for meeting IRS and taxpayer needs. The IRS can continue to gather data regarding the use of affidavits while expanding their use to all EITC examinations in the near future.

### **Improve the Process Of Transferring Correspondence Exams from Campuses to the Local Office**

Submissions to the TAS Systemic Advocacy Management System (SAMS) indicate that IRS procedures differ for granting transfers of examination from the campus to the field examination units. Some taxpayers may wish to have their exams worked in a nearby

<sup>50</sup> See National Taxpayer Advocate 2006 Annual Report to Congress at 376 (referring to Most Serious Problem on reasonable accommodations).

<sup>51</sup> IRM 21.3.6.4.1 (Oct. 1, 2006); IRM 21.3.6.4.2 (Oct. 1, 2006).

<sup>52</sup> National Taxpayer Advocate 2004 Annual Report to Congress Vol. 2, at 19 (noting documentation difficulties or deficiencies with original audit were cause of audit reconsideration in 45 percent of cases examined).

<sup>53</sup> IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005* (Oct. 2005). The IRS conducted the second certification study from December 2004 through April 2005 for TY 2004. The study looked at a random sample of 25,000 EITC claimants for whom the IRS could not establish qualifying child eligibility through available data. The 2004 certification study marked the first time IRS examination routinely used affidavits for tax administration purposes. *Id.* at 8.

<sup>54</sup> IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005*, 33 (Oct. 2005). The 2004 certification study was the first time the IRS used the affidavit. Because the affidavit was new, taxpayers may have been very cautious when filling it out, which may have affected the accuracy rate. For a complete discussion of the use of the affidavit during the 2004 certification study, see IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005* (Oct. 2005).

IRS office as opposed to a campus that may be outside the taxpayer's area. Treas. Reg. § 301.7605-1(e) provides detailed instructions on how a taxpayer may request the IRS to transfer an examination scheduled at one location to another, and numerous IRS publications discuss a taxpayer's request for a transfer of his or her examination.<sup>55</sup> Although field examination guidelines reference the Regulation and give details of how to handle transfer requests, campus guidelines contain no such information.<sup>56</sup>

The campus examination manual does not reference the Regulation and instead instructs employees that if a taxpayer wants a transfer to a local office, the examiner should telephone the taxpayer to assure him or her that the campus can resolve the exam.<sup>57</sup> Only when the taxpayer "insists" on a transfer will the Exam employee forward the case to management for approval to transfer to the local office. Given that some taxpayers want to be able to meet face-to-face with the IRS when navigating the complicated exam process, the IRS should make every effort to ensure that it does not discourage taxpayers' efforts to have their exams transferred to a local office.

### Promote Available Taxpayer Services

The TAS Impact of Representation study discussed previously shows that representation impacts the outcome of EITC exams. Based on the outcome of the study, the IRS should do everything it can to promote available services such as the LITCs and TAS and educate taxpayers about their existence. Although the IRS may not be able to provide representation to every taxpayer subject to exam, the IRS can do more to ensure taxpayers have access to much needed representation.

### Low Income Taxpayer Clinics

The LITC Program is a grant program under IRC § 7526 in which qualified organizations receive matching federal grants to represent low income taxpayers in controversies before the IRS or provide tax outreach and education to English as a second language (ESL) taxpayers. While current funding limits the number of LITCs that receive grant awards, today 150 clinics play a vital role in ensuring that low income taxpayers have access to competent representation before the IRS.

The IRS can help taxpayers by promoting the existence of LITCs and their services. Although the clinics conduct their own publicity, they cannot reach every taxpayer in need

<sup>55</sup> IRS Pub.1, *Your Rights as a Taxpayer*; Pub. 17, *Your Federal Income Tax for Individuals*; Pub. 556, *Examination of Returns, Appeal Rights, and Claims for Refund*; Pub. 3498, *The Examination Process*.

<sup>56</sup> IRM 4.11.29.4, Examination Officers Guide 9EOG – Transfer of Returns Open for Examination (Apr. 1, 2005).

<sup>57</sup> If the examiner is unable to contact taxpayer by telephone, they are instructed to issue Letter 1654 and refile case for remaining suspense period. Letter 1654 states:

We have considered your request to transfer your (blank) federal income tax return to the area office for examination. Please try to work with the service center first to resolve this matter by mail. We encourage you to do this because your file is already at the center and the staff there is familiar with your case and can handle the matter promptly and efficiently.

of assistance. IRS employees cannot refer a taxpayer to a specific LITC,<sup>58</sup> but they can and should refer taxpayers to the clinics in their areas if they need assistance during or after an exam. IRS employees can provide taxpayers with a copy of Publication 4134, *Low Income Taxpayer Clinic List*, which lists all LITCs by city and state, the services provided, and the languages spoken. A map on the LITC pages of the TAS website link taxpayers to the clinic(s) in their states.<sup>59</sup>

### **Taxpayer Advocate Service**

In addition to the LITCs, the IRS should also promote TAS as an alternative for taxpayers in need of help during the exam process. TAS cannot provide representation in the same way that the LITCs or other *pro bono* representatives can, but TAS employees can assist taxpayers throughout the examination process.

While TAS is not a replacement for IRS assistance, the IRS should refer cases to TAS when they meet TAS criteria. If a taxpayer meets TAS criteria and is in need of assistance the IRS is unable to provide during the exam process, the case should be referred to TAS. TAS case advocates can walk taxpayers through the exam process, and explain what is happening and what the taxpayer needs to do. TAS can also assist taxpayers in obtaining needed documentation.

### **Taxpayer Assistance Centers**

The IRS should also promote the availability of Taxpayer Assistance Centers (TACs). Many low income taxpayers have indicated a wish to talk face-to-face with the IRS when trying to resolve a problem.<sup>60</sup> The current IRS policy of conducting EITC exams by correspondence makes it difficult to provide face-to-face contact. Although not every taxpayer subject to an EITC exam wants to meet with an IRS employee, the IRS should consider offering this option to those who may need it. The IRS has 400 open TAC offices across the United States and Puerto Rico.<sup>61</sup> TAC employees are trained to prepare tax returns, answer certain tax law questions, and respond to other taxpayer issues. The IRS should promote the TAC offices as an alternative method of assisting taxpayers in understanding the exam process. A taxpayer should be able to take his or her letter into an IRS office and meet with a TAC employee to discuss the exam, what documents the IRS needs, and the best way to obtain them. This is one way for the IRS to use an existing taxpayer service to help taxpayers overcome the barriers presented by the exam process.

<sup>58</sup> For a detailed discussion of the ability of IRS and TAS employees to refer a taxpayer to a specific LITC, see Additional Legislative Recommendation, Referral to Low Income Taxpayer Clinics, *infra*.

<sup>59</sup> LITC map, available at <http://www.irs.gov/advocate/content/0,,id=151026,00.html>.

<sup>60</sup> Taxpayer Advocate Service, *Challenges for Taxpayers Claiming the Earned Income Tax Credit (EITC)*, From *Interviews with Low Income Tax Clinics* (Sept. 2005). The surveys conducted as part of the IRS's Taxpayer Assistance Blueprint (TAB) found that 73.5 to 84 percent of taxpayers earning less than \$35,000 prefer getting help in person from the IRS compared with 64.5 to 71.7 percent of those with incomes of \$35,000 or more. IRS Oversight Board, *2006 Service Channels Survey*, 12 & D5. See also *Study of Taxpayer Needs, Preferences, and Willingness to Use IRS Services*, National Taxpayer Advocate 2006 Annual Report to Congress, Vol. 2 at 6.

<sup>61</sup> For a detailed discussion of the TACs, see Most Serious Problem, Service at Taxpayer Assistance Centers, *supra*.

## IRS Comments

The IRS agrees with the National Taxpayer Advocate that it is not feasible to provide representation for every taxpayer and that various alternatives exist. The IRS also agrees that continued efforts to simplify the existing examination process and to promote available taxpayer services are important to reaching the correct audit conclusion. As a result, the IRS is continually taking steps to improve the examination process, increase the effectiveness of our telephone communications with taxpayers, simplify our written correspondence, address the needs of Limited English Proficient (LEP) taxpayers, and promote the availability of free taxpayer services.

The EITC program's goals are twofold – to ensure that the EITC is claimed by every eligible taxpayer and to reduce EITC error. With regard to the latter, the IRS's EITC examination strategy provides an effective compliance program to help combat the estimated \$10 billion to \$12 billion in EITC paid in error each year. The input the IRS receives from internal and external stakeholders for this strategy, including our continued partnering with the National Taxpayer Advocate, has been extremely helpful in improving the examination process, while reducing taxpayer burden and protecting taxpayer rights.

### Simplify the Examination Process

We appreciate the National Taxpayer Advocate's recognition of the many recent improvements to the EITC examination process including increased use of telephone communications, new Intelligent Call Management, extension routed calling, and toll-free fax numbers. Two other notable improvements include developing a more effective EITC case selection methodology and implementing a professional decision making process for EITC examiners.

The IRS revised its EITC examination case selection methodology to make better use of information already available and to apply better filters to select taxpayers most likely to have claimed EITC in error. This means that fewer taxpayers entitled to receive EITC are burdened with an examination and delay in receiving their credit.

The IRS also implemented the concept of professional decision making, which gives examiners the latitude and encourages them to use sound professional judgment to make decisions on the adequacy of documentation during the audit process. For example, examiners can now allow the taxpayer to provide documentation based upon their unique individual situation, rather than requiring only standard documents. Examiners are encouraged, after careful consideration, to make a determination based on the totality of the information provided rather than holding the taxpayer to strict, inflexible requirements. These procedures have resulted in fewer overage cases and reduced cycle time, which translates to reduced taxpayer burden and better taxpayer service.

### Increase Communication with Taxpayers

The National Taxpayer Advocate's report notes that procedures have already been revised to encourage telephone contact to resolve EITC examination issues. In addition, employees providing telephone assistance on unassigned cases are now allowed to reassign a case to their inventory from any campus if they can close the case.

As an alternative to correspondence, if a telephone number has been provided, examiners now routinely call the taxpayer or their representative when:

- The information submitted is not sufficient to allow a questionable item;
- Clarification is needed for information submitted by the taxpayer; or
- The taxpayer does not respond to a written inquiry.

However, taxpayers do not always provide a telephone number and it is not always possible to find one through the telephone listings or directory assistance. In these cases, the only recourse is to correspond with the taxpayer.

During the latter part of FY 2007, W&I Reporting Compliance also implemented a new procedure called "Self Assign" to expedite examiner resolution of unassigned cases. This new process allows an examiner providing telephone assistance on an unassigned case to immediately reassign the case from any campus to their own inventory when the taxpayer provides sufficient information to close the case. We expect this new procedure will significantly reduce the time needed to close these cases and improve customer satisfaction.

### Simplify Correspondence

The IRS agrees that we need to improve the quality of our correspondence. To that end, we implemented a continuous, data driven quality improvement strategy that engages internal and external stakeholders, including the National Taxpayer Advocate, to help us revise our written communications to better meet taxpayer needs. This process was recognized as a model of excellence in the 2006 Report to Congress.

The IRS continues to use this process to improve EITC-related written communications. In FY 2007, the IRS reviewed two significant EITC documents — Form 886-H-EIC, Documents You Need to Prove You Can Claim an Earned Income Credit On the Basis of a Qualifying Child or Children, and Letter CP 75, the initial contact letter for EITC examinations. The IRS also revised Publication 3498-A, The Examination Process (Examination by Mail), to provide focused information on correspondence examination and expanded taxpayer access to Appeals. The Form 8862, Information to Claim Earned Income Credit after Disallowance, was also simplified to reduce taxpayer burden and is now available in Spanish and Braille.

Changes to Form 886-H-EIC deserve special mention because they were based in large part on input from the Taxpayer Advocacy Panel (TAP). The TAP then used a document



assessment tool that assigns a score (from a highest rating of A+ to a lowest rating of F-) based on three categories: message and task, logical structure, and presentation. The new form received an “A” score. The W&I Notice Improvement Office, in coordination with W&I Research, also conducted focus groups at two of the 2007 Nationwide Tax Forums to test the new TAP-approved form. The Tax Forum participants felt the form was clear, straightforward, and they liked the general grid-like layout. Finally, to better meet the needs of English as a Second Language taxpayers, in addition to a Spanish version of Form 886-H-EIC, IRS now includes a Spanish-language phrase on the English version of this form indicating that a Spanish version is available.

### **Address the Needs of the ESL (English as a Second Language) and Disabled Taxpayers**

IRS continues to improve and expand the services it provides for ESL and disabled taxpayers. Spanish speaking IRS tax examiners assist Spanish speaking taxpayers, who make up the majority of the ESL population. Campuses maintain listings of bi-lingual employees who volunteer to assist with translating written correspondence when the need arises. Additionally, our toll free telephone service provides assistance in Spanish.

The IRS Stakeholder Partnerships, Education and Communication (SPEC) organization partners with organizations who provide outreach, education and assistance to taxpayers in diverse communities, including Limited English Proficient (LEP). In addition to Spanish, these organizations translate EITC products for their clients into more than 27 languages including Somali, Bosnian, Russian, East African, and Vietnamese. SPEC is in the process of developing an LEP outreach and education strategy that will contain an EITC component. In addition, SPEC also implemented a disability initiative that successfully engaged 26 national partners in over 100 U.S. cities to assist the visually impaired and other taxpayers with disabilities.

In addition, in FY 2007, the IRS sent a direct mail package to a half million taxpayers in ten Hispanic markets to provide information on EITC and assistance available to them. The FY 2007 EITC Awareness Day, presented in partnership with community based organizations, included an ESL focus. Building on the success of that effort, our plans for the FY 2008 EITC Awareness Day include expanded efforts to reach and assist ESL taxpayers.

With regard to taxpayers with disabilities, the IRS will continue to review its policies and procedures to identify opportunities to assist them. IRS telephone assistors who make referrals to our Alternative Media Center to provide copies of notices in alternative formats, such as Braille, to taxpayers, also put a hold on balance due accounts when appropriate, per IRM 21.3.1.5. The IRS also revised its procedures to allow taxpayers with special needs, such as a disability, to make appointments via telephone to receive service at Taxpayer Assistance Centers, eliminating the burden of waits. The IRS partnered with advocacy groups to conduct a research project to determine the needs of taxpayers with vision impairments. The IRS will use the results of the research project to develop a long-term

strategy, expected in 2009, to assist taxpayers with vision impairments, including senior taxpayers with vision impairments.

### **Adopt the Use of Affidavits**

The analysis of the three-year EITC certification test and use of affidavits is ongoing. The IRS will review all results before making a final decision regarding expanded use of certification and/or affidavits. One concern is that the IRS testing of residency affidavits for the certification test did not replicate “real world” conditions under which affidavits might be used. As a result, it would be premature to expand use of affidavits in all EITC correspondence examinations until the test results are fully analyzed. In addition, prior to any such expansion, it will be necessary to develop a comprehensive approach to identify and prevent submission of false affidavits.

Although the residency affidavit is not used in correspondence examinations, taxpayers can still submit letters from third parties along with other documentation to support their claims. The newly revised Form 886-H-EIC clearly lays out the various options available for taxpayers to document that they meet the EITC requirements. Also, as previously noted, the use of new examiner professional decision making authority makes the documentation process more flexible and less burdensome for taxpayers.

### **Improve the Process of Transferring Correspondence Exams from Campuses to the Local Office**

The National Taxpayer Advocate cites Treas. Reg. 301.7605-1(e) as providing detailed instructions on how a taxpayer may request the IRS to transfer an examination from one location to another. The report notes that, although field examination guidelines reference these regulations, campus guidelines contain no such information. However, this regulation addresses office and field examinations; it does not specifically address examination transfer requests from the campus to a local office.

The IRS selects cases for the campus or office/field based on the complexity of the work. The campus environment is generally more conducive to EITC examinations. As a result, existing campus EITC examination procedures, outlined in IRM 4.19.13.14, direct examiners to call a taxpayer who has requested a transfer. The examiner’s purpose is to ensure the taxpayer understands the audit issues at hand, including the documentation needed to substantiate the issue, and answer any questions. If the issue can be resolved with correspondence without having the taxpayers schedule time to attend a face-to-face meeting, the IRS can expeditiously resolve the case. If the taxpayer still wishes his or her case to be transferred, it may be transferred based upon the resources available locally and time remaining on the statute of limitations.

***Promote Available Taxpayer Services***

The IRS agrees that taxpayers should be aware of the services offered by the Low Income Taxpayer Clinics (LITCs), the Taxpayer Advocate Service, and at IRS Taxpayer Assistance Centers (TACs). Multiple avenues are used to disseminate this important information, including IRS publications, taxpayer correspondence, outreach and education efforts, and IRS.gov.

Publication 3498-A, The Examination Process (Examinations by Mail), is mailed as part of the initial contact package on every EITC examination. It outlines the right to representation during the audit process and advises that if the taxpayer cannot afford representation, the taxpayer may be eligible for assistance from the LITCs. Services offered by the TAS are also included in this publication. CP 75, the EITC examination initial contact letter, includes references to TAS and LITCs. This contact letter is issued with Publication 4134 that lists the LITCs and the language assistance services available. Statutory Notices of Deficiency were revised in February 2001 to include the TAS telephone number. IRS.gov includes sections on TAS, LITCs, and TACs. Publication 17, Your Federal Income Tax, and Publication 596, Earned Income Credit, include TAS and LITC information. In addition, our 2008 EITC Awareness Day will specifically focus on the free services available to EITC taxpayers, including those provided by TACs, LITCs, TAS, and Volunteer Income Tax Assistance within local communities.

With regard to IRS employees referring taxpayers to TAS, there are various references in IRM 4.13 and 4.19, as well as in examination training materials, about referring cases to TAS when the criteria is met. Referral criteria and procedures are covered during annual examiner refresher training. In addition, employee adherence to these procedures is also monitored as part of our regular managerial and quality review processes.

**Taxpayer Advocate Service Comments**

The National Taxpayer Advocate is pleased that the IRS agrees with the need to continue simplifying the examination process, and is eager to continue to work with the IRS on its simplification efforts. The IRS's response shows that the IRS is making *significant* strides in improving the EITC examination process. The National Taxpayer Advocate believes that both goals of the EITC program – ensuring all eligible taxpayers claim the credit and reducing EITC error – can be furthered by adopting the recommendations contained in this report.

While the IRS may agree in principle with the need for simplification of the examination process, the National Taxpayer Advocate is baffled by the IRS's reluctance to adopt the use of affidavits in EITC examinations. We have made a similar recommendation in a previous report, but the IRS continues to state that additional information is necessary before the affidavits can be implemented. The IRS will never know the accuracy of affidavits under

“real world” conditions without expanding their use beyond the EITC Certification test. Without further testing, the IRS will not be able to identify potential problems and develop solutions, allowing for a more widespread use of affidavits in EITC examinations. We agree that it is important for the IRS to create procedures to prevent the use of false affidavits. However, the potential for false affidavits is no reason to continue stalling the adoption of a potentially valuable tool in the examination process. Moreover, the IRS should let the professional judgment of taxpayers play a role in the process. If examiners are now being empowered to use their professional judgment in determining the sufficiency of documentation, the same judgment can be applied to the use of affidavits. IRS employees, with appropriate training, can identify suspect cases and make phone calls to affiants to confirm their statements.

The IRS’s efforts to revise its case selection and examination processes are steps in the right direction of improving the examination process. The National Taxpayer Advocate is very supportive of IRS efforts to reduce delay in allowing eligible taxpayers to receive their much-needed refunds. Further, the introduction of “sound professional judgment” into the examination process is necessary to ensure that a decision on a taxpayer’s case is based on all available information. TAS employees have received extensive guidance to exercise common sense and good judgment in TAS case processing.<sup>62</sup>

To ensure that examiners reach the right result in EITC examinations, the use of judgment is necessary and we are pleased that the IRS is encouraging examiners to exercise their judgment. The IRS should continually train its employees on the issue of “judgment” to ensure that taxpayers are not receiving disparate treatment based on which examiner is assigned to their case, and use real world examples to discuss how the application of judgment would affect the case.

The National Taxpayer Advocate commends the IRS for its efforts to increase contact with taxpayers or their representatives. The research discussed earlier demonstrates the positive effect that telephone contact with taxpayers can have on the outcome of EITC examinations. To increase examiners’ ability to initiate telephone contact with taxpayers, we recommend that the IRS make additional efforts to obtain taxpayer telephone numbers. In instances where a taxpayer calls the IRS, the IRS assistor should try to obtain the taxpayer’s phone number or confirm an existing number on file to allow for follow up on the case.

The IRS’s new procedure of allowing examiners to “self assign” unassigned cases to facilitate case resolution is another positive step toward simplifying the examination process. These procedures should prevent taxpayers from being transferred from examiner to examiner. The National Taxpayer Advocate is interested to see whether the new procedures assist in expediting case resolution and result in fewer cases ending up in TAS.

<sup>62</sup> Taxpayer Advocate Service, *Common Sense and Good Judgment in Case Processing II*, available at <http://www.irs.gov/irm/part13/ch01s16.html>.

The National Taxpayer Advocate and TAS employees will continue working with the IRS to simplify correspondence. The National Taxpayer Advocate is pleased that the IRS used recommendations from the TAP as a basis for revising Form 886-H-EIC. The IRS should continue to engage both TAP and LITCs in the process of revising IRS forms, publications and correspondence. LITCs in particular have significant experience and expertise in working and communicating with the EITC population.

In addition to the recent changes in EITC-related forms and correspondence, the IRS should continue to review correspondence to eliminate confusing boilerplate language (where language is mandatory, the IRS should attempt to use “plain English,” not legalese). The IRS should work to include taxpayer-specific information in examination correspondence so that taxpayers can understand exactly what they need to do to resolve their cases

The National Taxpayer Advocate commends the IRS and SPEC on their efforts to increase outreach to all taxpayers, especially ESL and disabled taxpayers. TAS was pleased to take part in the 2007 EITC Awareness Day and looks forward to continuing this partnership in 2008, and to working with the IRS on a long-term strategy for responding to the needs of taxpayers with vision impairments.

While the IRS has made strides in addressing the needs of ESL and disabled taxpayers, there is still room for improvement. The IRS should work to expand its available language services to languages other than English and Spanish. Such services include translating forms, publications, and correspondence into languages such as Korean, Mandarin, Arabic, and Vietnamese. The IRS should also expand its use of the interpreter services available on the toll-free phone number. Finally, the IRS should train assistants to be sensitive to the needs of ESL taxpayers and recognize when they may need the services of interpreters.

The National Taxpayer Advocate is extremely pleased that the IRS has made Form 886-H available in Braille – this is a tremendous first step. However, the IRS can also do more to meet the needs of disabled taxpayers and reduce barriers to working with the IRS. These steps should include giving taxpayers the ability to obtain Braille copies of forms and publications through the Alternative Media Center. Further, the IRS should investigate allowing taxpayers with disabilities to indicate that they wish to receive future IRS correspondence in Braille, at least in the context of controversies with the IRS and other tax compliance actions. The National Taxpayer Advocate made these recommendations to the IRS in her 2006 Annual Report to Congress and we again reiterate the important role these changes can play in helping to remove obstacles for disabled taxpayers.<sup>63</sup>

The IRS states that “[t]he campus environment is generally more conducive to EITC examinations.” While this may be true from the perspective of the IRS, it may not necessarily be true for taxpayers. The IRS should reexamine its current guidelines regarding the transfer of cases from the campus to field offices. When a taxpayer feels a face-to-face meeting or

<sup>63</sup> National Taxpayer Advocate 2006 Annual Report to Congress at 394-95.

local knowledge is necessary to resolve a case and the taxpayer or his or her representative requests a transfer from the campus, the IRS should honor that request unless there are unusual circumstances. A reexamination of current policies should consider ways to address the IRS's concerns about available resources and the statute of limitations.<sup>64</sup>

The National Taxpayer Advocate is pleased that the IRS recognizes the key role that LITCs, TAS, and TACs play in the examination process. While the IRS does promote the availability of taxpayer services in certain publications and notices, it should consider which additional materials should contain information about TAS and LITCs.

The IRS should also work with TAS to educate IRS employees on identifying cases in which taxpayers would be better served by being referred to LITCs or TAS.<sup>65</sup> Further, the W&I and SB/SE exam functions should work with Field Assistance to determine when taxpayers should be referred to a TAC for assistance in obtaining documentation necessary to resolve their cases.

## Recommendations

The National Taxpayer Advocate applauds the IRS for its improvements to date in the EITC examination process and recommends the IRS take the following steps to improve the current IRS exam strategy to ensure the IRS is reaching the right result for all taxpayers:

- Conduct additional testing on the use of affidavits in examinations;
- Expand the use of the affidavit to all EITC examinations;
- Test other potential methods of proof in IRS examinations to determine which methods are most accurate and best suited for meeting IRS and taxpayer needs;
- Provide continual training to examiners on the topic of exercising “judgment” in taxpayer cases using real case examples;
- Make additional attempts to obtain taxpayer telephone numbers for follow up contact in resolving cases;
- Replace boilerplate language in correspondence with taxpayer-specific information explaining what that specific taxpayer needs to do to resolve his or her case;
- Make IRS correspondence, forms and publications available in languages besides English and Spanish;
- Expand the interpretation services available on the toll-free telephone lines;

<sup>64</sup> The Regulation referenced was enacted in 1954. It has subsequently been amended, with the latest amendment in April 1993. The Regulation does not specifically address the transfer for campus examinations to local offices because it was last amended at a time before the IRS was conducting a large number of examinations at its campuses.

<sup>65</sup> Although the IRS cannot refer taxpayer to a specific LTC, it can send taxpayers Publication 4134, direct taxpayers to the TAS website, or provide them with a list of the clinics in their geographic area.

- Increase publicity about the Alternative Media Center and taxpayers' ability to obtain Braille copies of forms and publications;
- Give taxpayers the option of specifying that they would like to receive correspondence in Braille, particularly in the context of IRS compliance activity;
- Reexamine current guidance regarding the transfer of cases from the campus to field offices to ensure that in cases where a face-to-face meeting or local knowledge is helpful in resolving the case, taxpayers' requests for a transfer are not ignored due to resource and statute of limitations issues;
- Identify additional publications and notices that would benefit from the inclusion of language related to the LITCs and TAS; and
- Work with Field Assistance to determine when taxpayers should be referred to a TAC in cases where they may need assistance in obtaining documentation necessary to resolve their cases.



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## Nonfiler Program

### Responsible Officials

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### Definition of The Problem

An estimated \$25 billion of the tax year 2001 gross tax gap is attributable to individuals who do not timely file tax returns.<sup>1</sup> This amount increased 33 percent from tax year 1998 to 2001, an indication that the IRS has not effectively addressed this area of noncompliance.<sup>2</sup>

In fiscal year (FY) 2006, the IRS used automation to enforce individual filing compliance, generating more than 1.2 million cases, more than 60 percent of which resulted in default assessments.<sup>3</sup> In FY 2007, the IRS collected just under two percent of the taxes assessed through the automated process, a sign that this method is not increasing filing and payment compliance.<sup>4</sup>

The IRS charted an agency-wide course of action for nonfilers, but has not consistently focused on its plan, and responsibility for the components of this action plan is fragmented throughout the IRS. A balanced strategy of research, service, and enforcement effort is needed to successfully increase filing compliance. The IRS must consider the impact of the following issues on compliance:

- IRS organizational changes impacting nonfilers;
- Taxpayer attitudes influencing behavior; and
- Compliance risk and associated downstream costs.

<sup>1</sup> IRS Office of Research, *Tax Gap Map for Tax Year 2001* (Feb. 2006). The National Research Program study estimated that the “gross tax gap” was about \$345 billion and the “net tax gap” (i.e., the gross tax gap reduced by late payments and amounts collected as a result of IRS enforcement actions) was about \$290 billion. The individual nonfiler component is an estimate based on U.S. Census data.

<sup>2</sup> Treasury Inspector General for Tax Administration, Ref. No. 2006-30-006, *The Internal Revenue Service Needs a Coordinated Strategy to Better Address an Estimated \$30 Billion Tax Gap Due to Nonfilers 2* (Nov. 2005).

<sup>3</sup> IRS Data Book, Table 14, *Information Reporting Program 37* (Fiscal Year 2006) and IRS, *Enterprise-Wide Nonfiler Report* (April 2007).

<sup>4</sup> IRS, *National Delinquent Return Activity Report for National Totals* (Sept. 9, 2007).

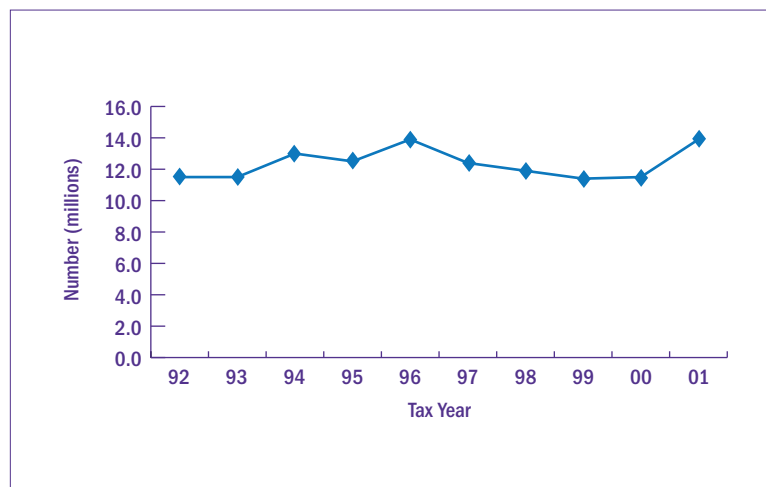
## Analysis of The Problem

### Background

A nonfiler is a taxpayer that has a filing requirement but has not filed a return by the original due date or the approved extension date.<sup>5</sup> Many of these taxpayers eventually file returns and are reclassified as late filers.

### Historical Trends

**CHART 1.16.1, Growth of Nonfilers and Late Filers<sup>6</sup>**



The IRS identifies known nonfilers through data such as information reporting or prior tax returns.

**TABLE 1.16.2, Number of Known Individual Nonfilers<sup>7</sup>**

	Tax Year 2003	Tax Year 2004	% Change <sup>8</sup>
W & I Individual Nonfilers	4,902,158	5,089,884	3.8%
SB/SE Individual Nonfilers	2,281,701	2,426,789	6.4%
<b>Total</b>	<b>7,183,859</b>	<b>7,516,673</b>	<b>4.6%</b>

<sup>5</sup> IRS, SB/SE Research, *The Nonfiler Problem- Part I* (March 2006).

<sup>6</sup> IRS, *Compliance Research Information* (Tax Years 1992-2001).

<sup>7</sup> IRS, SB/SE Research, *The Nonfiler Problem- Part I* (March 2006).

<sup>8</sup> Individuals filed 130,423,626 and 132,226,042 returns in tax years 2003 and 2004, respectively, representing a growth of 1.4 percent. IRS, Statistics of Income (SOI) Data, *Individual Income Tax, All Returns* (Fiscal Years 2005 and 2006).

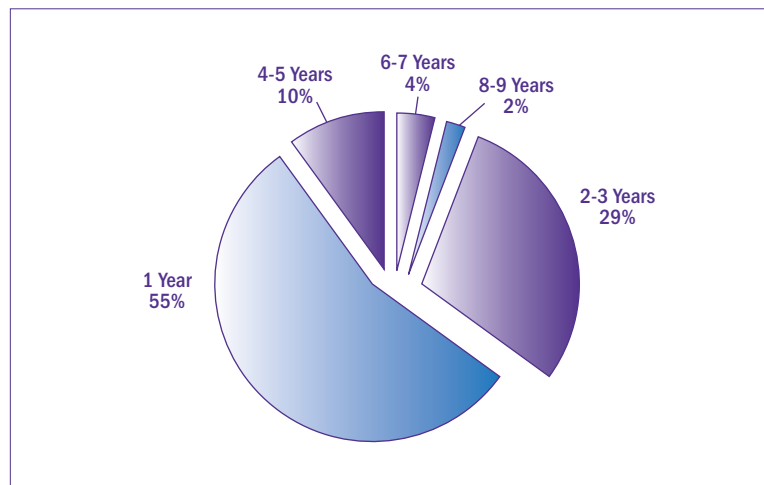
### Repeaters, Skip and Stop Filers

Taxpayers who fail to file returns generally fall into one of three categories:

- **Repeat nonfilers** are noncompliant in the year they are identified and one or both of the previous two tax years;<sup>9</sup>
- **Skip filers** file in some years and not in others; and
- **Stop filers** filed for a number of years, then stopped.

IRS systems for identifying nonfilers do not categorize taxpayers based on the number of years a taxpayer has not filed, so the IRS cannot adequately develop methods of dealing with one-time nonfilers versus repeaters, skip and stop filers. However, repeat nonfilers make up a significant portion of the overall nonfiling population.<sup>10</sup>

**CHART 1.16.3, Percent of Individual Nonfilers for Tax Years 1996-2004 by Number of Tax Years They Failed to File<sup>11</sup>**



Recidivism in filing behavior presents a challenge for the IRS. Willful failure to file a return is presently a misdemeanor.<sup>12</sup> The Treasury Department recently proposed legislation to reclassify the crime as a felony for taxpayers who fail to file in any three years within

<sup>9</sup> IRS, SB/SE Research, *High Income Repeat IMF Nonfiler Compliance Study 1* (April 30, 2006). IRS internal data was used to extract a population of 291,502 individuals with information return program data of \$100,000 or more and who did not file a tax year 2000 return and either (or both) a tax year 1998 or tax year 1999 return. The IRS tracked compliance behavior of the population over a two-year period and concluded that the study group made up only three percent of all tax year 2000 nonfilers, but accounted for 41 percent of all estimated taxes and 45 percent of all projected underpayments by nonfilers. The tax year 2000 total projected taxes were \$186.4 billion.

<sup>10</sup> IRS, SB/SE Research, *The Nonfiler Problem- Part II* (Mar. 24, 2006).

<sup>11</sup> IRS, SB/SE Research, *Repeat Nonfilers 1* (Mar. 30, 2007).

<sup>12</sup> Title 26 USC § 7203.

a period of five consecutive years if the aggregate tax liability for the period is at least \$50,000.<sup>13</sup>

Although the number of nonfilers is growing, taxpayers who do not file required returns do not always owe taxes. In tax year 2003, there were 6.1 million potential individual nonfilers,<sup>14</sup> a significant number of whom were likely due refunds based on information reporting documents:<sup>15</sup>

**TABLE 1.16.4, Percent of Individual Known Nonfilers Due Refunds, Have a Balance Due, or Owe No Taxes for Tax Year 2003<sup>16</sup>**

	W & I Individuals <sup>17</sup>	SB/SE Individuals <sup>18</sup>
Refund	34.9%	14.0%
Balance Due	65.9%	85.9%
Zero Balance Due	.2%	.1%

In FY 2006, the IRS established an executive group, the Collection Governance Council, to oversee an enterprise-wide nonfiler strategy and develop the first servicewide nonfiler work plan.<sup>19</sup> The group held nonfiler summits, but did not develop a strategy involving all IRS operating divisions.<sup>20</sup> In FY 2007, the IRS formed the Servicewide Nonfiler Executive Advisory Council. The council's draft charter states:

The Servicewide Nonfiler Executive Advisory Council mission is to serve as the primary coordination body for IRS on matters related to nonfiling of tax returns across all operating divisions under the Deputy Commissioner for Services and Enforcement. It will guide the development of Servicewide strategies for improving resource allocation to reduce noncompliance and the tax gap. The Servicewide Nonfiler Executive Advisory Council will serve as a principal advisory board to the Enforcement Committee, chaired by the Deputy Commissioner for Services and Enforcement.

<sup>13</sup> Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2008 Revenue Proposals* 79 (Feb. 2007).

<sup>14</sup> In tax year 2003 there were 7.2 million potential individual nonfilers, 1.1 million of which filed late, leaving 6.1 million individual nonfilers. IRS, SB/SE Research, *The Nonfiler Problem - Part II* (March 2006).

<sup>15</sup> IRS, SB/SE Research *The Nonfiler Problem - Part II* (March 24, 2006).

<sup>16</sup> *Id.* at 1.

<sup>17</sup> Wage and Investment Division.

<sup>18</sup> Small Business/Self-Employed Division.

<sup>19</sup> Treasury Inspector General for Tax Administration, Ref. No. 2006-30-006, *The Internal Revenue Service Needs a Coordinated Strategy to Better Address an Estimated \$30 Billion Tax Gap Due to Nonfilers* 4 (Nov. 2005).

<sup>20</sup> SB/SE response to TAS research request (June 8, 2007).

The IRS needs this centralized oversight for nonfiler research, service, and enforcement activities. The present focus is on enforcement strategies to reduce the tax gap.<sup>21</sup> An effective strategy to increase and maintain high levels of filing compliance needs a more balanced approach, and with a TAS executive participating on the Servicewide Nonfiler Executive Advisory Council, TAS plans to be involved up front in formulating that strategy.

### IRS Organizational Changes Impact Nonfilers

The IRS emphasis on automated systems and its corresponding reduction in face-to-face service negatively impacts certain segments of the taxpayer population and contributes to the filing compliance problem.

#### *Automated Systems Generate Significant Default Assessments and TAS Casework.*

The IRS developed Substitute for Return (SFR) procedures to assess tax based on information reporting documents or other internally available information.<sup>22</sup> The IRS populates the Automated SFR (ASFR) program with taxpayer data based on criteria such as the number of information reporting documents and potential tax liability. The program generates notices asking taxpayers to file returns or explain why they are not due.<sup>23</sup> The notice includes a list of income reported to the IRS under the taxpayer's identification number by third parties and the proposed tax assessment if no return is filed. Failure to file a return or respond to the notice leads to a default assessment, which occurred over 60 percent of the time in FY 2006.<sup>24</sup>

If a taxpayer submits correspondence about a notice, IRS employees working ASFR cases are directed to attempt to contact the taxpayer by phone at least twice before providing a written reply.<sup>25</sup> The IRS also staffs a telephone line for the ASFR program and measures quality by monitoring calls and reviewing closed cases for timeliness, professionalism, customer accuracy, regulatory/statutory accuracy, and procedural accuracy.

Notwithstanding high quality ratings, the program continues to report high default assessments, low collection percentages, and significant downstream consequences in the form of TAS casework.<sup>26</sup> In FY 2006, TAS received over 10,000 requests for assistance related to the ASFR program.<sup>27</sup> TAS cases often arise when the IRS claims it did not receive a taxpayer's filed return and freezes the refund.<sup>28</sup> In such instances, TAS case advocates work with the taxpayer and the IRS to secure and process an accurate return.

<sup>21</sup> IRS Today, *Putting the Squeeze on Nonfilers* (Nov./Dec. 2006).

<sup>22</sup> IRC § 6020(b), which provides that "If any person fails to make any return required by an internal revenue law or regulation...the Secretary shall make such return from his own knowledge and from such information as he can obtain through testimony or otherwise." See IRM 4.4.9 (Feb. 1, 2006).

<sup>23</sup> A SFR case is typically worked through field contact, whereas an ASFR case is an automated process.

<sup>24</sup> IRS, *Enterprise-Wide Nonfiler Report* (Apr. 2007).

<sup>25</sup> IRM 5.18.1.10.2.3.13 (1) (Oct. 1, 2005).

<sup>26</sup> IRS, *Enterprise-Wide Nonfiler Report* (Apr. 2007) and see Most Serious Problem, *Audit Reconsiderations*, *infra/supra*.

<sup>27</sup> IRS Data Book, Table 20 *Taxpayer Advocate Service: Postfiling Taxpayer Assistance Program, by Type of Issue and Relief* (Fiscal Year 2006).

<sup>28</sup> IRC § 6402(b). A current year refund is frozen when the IRS identifies a prior year return filing requirement with potential tax due and no return was filed.

**TABLE 1.16.5, TAS ASFR Relief<sup>29</sup>**

Fiscal Year	TAS Case Closures	Percentage of Closed Cases with Relief Granted	
		Full	Partial
2004	4697	54.82	7.45
2005	5050	57.63	6.61
2006	5588	57.53	7.41
2007	7857	66.67	5.46

The automated nature of the ASFR process results in taxpayers receiving notices without any human involvement to evaluate whether an assessment is reasonable. In some TAS cases, taxpayers received notices in which their incomes as reported to the IRS had more than doubled because erroneous Forms 1099 were issued in their names. A simple human review would have allowed these taxpayers to avoid the significant burden of rectifying these errors.<sup>30</sup>

The IRS needs to improve the automated selection process to reduce unnecessary contacts and assessments that burden taxpayers. Enhanced customer service options such as telephone contact prior to the first notice and electronic communication could accurately resolve more ASFR cases early in the process.

#### *Taxpayer Assistance Center (TAC) Policies Discourage Filing Compliance*

The reduction in walk-in IRS services impacts many low income and limited English proficiency (LEP) taxpayers and those with disabilities.<sup>31</sup> The IRS limits the number and type of tax returns it prepares for this population and requires taxpayers to visit a TAC office to set up appointments.<sup>32</sup> Each office has a maximum capacity for return preparation.<sup>33</sup> Taxpayers affected by these policies may give up, increasing the likelihood they will not file. However, the IRS does not track the volume of taxpayers it fails to assist or turns away due to a lack of resources.

The IRS made a conscious decision to reduce return preparation assistance in the TACs by encouraging taxpayers to use alternative methods to file returns, including Volunteer Income Tax Assistance (VITA) and “Free File,” which is offered online through the IRS

<sup>29</sup> The TAS case closures were extracted from the Taxpayer Advocate Management Information System (TAMIS) for cases closed in FY 2004, 2005, 2006, and 2007 with a Primary Issue Code 610 (ASFR).

<sup>30</sup> See Most Serious Problem, *Identity Theft Procedures*, *supra*.

<sup>31</sup> See Most Serious Problem, *Service At Taxpayer Assistance Centers*, *supra*.

<sup>32</sup> IRM 21.3.4.10.5. IRS and VITA sites do not prepare simple Schedule C returns for taxpayers who otherwise qualify for assistance. Recently proposed legislation (S.1219, 110th Cong. (§ 7526A (2007))) of the Taxpayer Protection and Assistance Act of 2007 introduced funding for volunteer sites to include simple Schedule C returns.

<sup>33</sup> Treasury Inspector General for Tax Administration, Ref. No. 2007-40-164, *The Internal Revenue Service Provides Helpful Tax Law Assistance but Still Has Problems With Tax Return Preparation Assistance* 24 (Aug. 2007).

website.<sup>34</sup> However, as the National Taxpayer Advocate has previously stated, many taxpayers need access to the IRS and return preparation assistance to comply with their tax obligations.<sup>35</sup> For example, immigrants for whom English is a second language frequently work as street vendors, merchants, or food service providers, use cash and money orders for expenses, rarely have credit cards or bank accounts, and do not keep records.<sup>36</sup> If these taxpayers lack government identification, they may not qualify for free return preparation and to avoid detection may remain part of the underground economy. Such taxpayers may become nonfilers out of fear due to language and cultural barriers, and need face-to-face communication with the IRS to promote filing compliance.<sup>37</sup>

The IRS must provide the best possible customer service to help taxpayers fully understand their obligations and make it easy and convenient to comply.<sup>38</sup> In 2000, the IRS phased out its “Problem Solving Days” and created a new “Everyday Tax Solutions” service for taxpayers to resolve problems.<sup>39</sup> The IRS touted the new service as more convenient and accessible than Problem Solving Days, but it was still limited by TAC staffing and accessibility.<sup>40</sup> Focus groups at the 2003 IRS Nationwide Tax Forums provided feedback on the new service, with comments such as “I had a set time but when I showed up no one was available to help,” and “Even with an appointment I still waited two and a half hours for an answer to a W-7 question.”<sup>41</sup>

The National Taxpayer Advocate urges the IRS to establish National Filing Days, similar to the former Problem Solving Days, early in the filing season and again near the individual tax return extended due date. Volunteers with training and access to prior year tax forms may assist taxpayers with filing current year tax returns as well as delinquent returns, forging a new path to filing compliance. Also, the IRS needs to partner with attorneys and other professionals to provide taxpayers with *pro bono* representation on collection arrangements.

### Taxpayer Attitudes Influence Behavior

The IRS has created extensive profiles of the characteristics of nonfilers based on return types, demographics, income, and industry.<sup>42</sup> While the IRS may know *who* does not file

<sup>34</sup> National Taxpayer Advocate 2004 Annual Report to Congress 19.

<sup>35</sup> National Taxpayer Advocate 2002 Annual Report to Congress v.

<sup>36</sup> *Taxpayer Advocate Report and Low Income Taxpayer Clinics: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 107<sup>th</sup> Cong., 1<sup>st</sup> Sess. (July 12, 2001) (testimony of Janet Spragens, Professor of Law and Director, Federal Tax Clinic, American University, Washington College of Law).

<sup>37</sup> *Id.*

<sup>38</sup> *The Effects of Tax Compliance Initiatives on Small Business, Hearing Before the H. Comm. on Small Business*, 109<sup>th</sup> Cong., 2<sup>nd</sup> Sess (April 5, 2006) (testimony of Nina E. Olson, National Taxpayer Advocate).

<sup>39</sup> Problem Solving Days were successful events held across the country to focus on resolving taxpayer problems with one-stop customer service. Everyday Tax Solutions was promoted as one-stop customer service on the taxpayer’s schedule with appointments at TACs recommended but not required.

<sup>40</sup> IRS, *Congressional Update*, Vol. 1 No. 3 (May 2002).

<sup>41</sup> IRS, W & I Research, *Everyday Tax Solutions Focus Groups 4* (Nov. 4, 2003).

<sup>42</sup> IRS, SB/SE Research, *Literature Review and Preliminary Recommendations on Measuring the Impact of Outreach on Nonfilers 3* (Jan. 2006).



returns, few studies exist on the reasons *why* taxpayers do not file. One study suggests that behavioral factors and taxpayer attitudes influence noncompliance. The reasons taxpayers cite for not filing include:

- Lack of money to pay taxes owed;
- Unfairness of the tax system; and
- Complexity of the tax code.<sup>43</sup>

The IRS has not studied the manner in which the beliefs, attitudes, and behavior of other people influence taxpayer filing compliance. To understand taxpayer behavior, the IRS must support research addressing the effect on tax compliance of factors that include social structure, cultural influences, demographics, and group dynamics.<sup>44</sup>

#### *Inadvertent versus Intentional Noncompliance*<sup>45</sup>

Certain economic and personal events can lead to inadvertent noncompliance:

- Illness or death of a family member;
- Change in marital status (divorce, separation);
- Lack of financial means;
- Recent economic loss (including loss of job);
- Loss of records due to a natural disaster; or
- Lack of English proficiency.

The IRS and its stakeholders need to help taxpayers who are experiencing genuine hardships and want to comply with the tax laws. Nonfilers are not only subject to federal income tax, penalties, and interest, which may lead to prolonged IRS collection activity, but their tax information is also shared with state taxing authorities who may take their own enforcement action. Taxpayers who foresee the consequences of coming forward to file delinquent returns after not filing for several years may be overwhelmed and choose to take their chances with detection.

When taxpayers intentionally disregard filing requirements after being advised of those requirements, the IRS must take timely enforcement action while preserving taxpayer rights. The IRS does not generally pursue enforcement of filing requirements for delinquent tax returns beyond six prior tax years and currently will not refer nonfilers for criminal prosecution if they voluntarily come forward, have only legal source income, file accurate

<sup>43</sup> Christina M. Ritsema, *Economic and Behavioral Determinants of Tax Compliance: Evidence from the 1997 Arkansas Tax Penalty Amnesty Program* 8, IRS Research Conference (2003).

<sup>44</sup> See Most Serious Problem, *Taxpayer Service and Applied Research, infra/supra* and Marjorie E. Kornhauser, *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*, Vol. II, *infra*.

<sup>45</sup> Inadvertent noncompliance includes taxpayers who are ignorant of filing requirements as well as those taxpayers who, due to an economic or personal event, failed to timely file a tax return. Intentional noncompliance describes those taxpayers who willfully or negligently fail to file a tax return.

returns, and pay their taxes.<sup>46</sup> The IRS should publicize its position on voluntary disclosure to promote filing compliance. Taxpayers who fear coming forward to file delinquent returns may consider it an opportunity to come clean and start anew with annual filings. If taxpayers are troubled by their failure to file and pay taxes, they may seize the chance to re-establish themselves in the tax system.

### *Different Treatment Options are Needed to Promote Filing Compliance*

Researching and developing approaches to address differing taxpayer needs must be a priority for the IRS in creating a comprehensive nonfiler strategy. The Taxpayer Assistance Blueprint Phase 2 process included comprehensive research into the needs, preferences, and behaviors of taxpayers as they try to comply with their tax obligations.<sup>47</sup> The National Taxpayer Advocate supports the efforts to develop a long-term strategy to meet taxpayer needs and preferences, which in turn should increase filing compliance.

### **Compliance Risk and Downstream Costs are High**

The IRS does not have sufficient resources to address every case of noncompliance; thus it must apply its enforcement efforts where noncompliance is greatest. The IRS needs to identify ways to transform attitudes about the tax system and create new norms of behavior, namely tax compliance.<sup>48</sup>

In FY 2004, the IRS implemented a High Income Nonfiler Initiative to secure delinquent returns from taxpayers with income of \$100,000 or more. This group represents only 17 percent of the total nonfiler population, but contributes 80 percent of the total balance due from nonfilers.<sup>49</sup> A small percent of nonfilers accounts for the majority of noncompliance dollars.

In addition to allocating enforcement resources, the IRS needs to measure the cost of downstream consequences in relation to its anticipated return on investment. For example, the ASFR program may generate significant closures and assessments, but if the IRS does not collect the assessments the burden shifts from filing compliance to payment compliance.

The downstream costs of ineffective service are also high. Potential costs include repeated contacts, errors on filed returns, revenue loss, and potential enforcement costs.<sup>50</sup>

<sup>46</sup> IRM 4.19.17.1(4) (Nov. 10, 2006).

<sup>47</sup> IRS, *Taxpayer Assistance Blueprint Phase 2* (Apr. 2007). The Taxpayer Assistance Blueprint (TAB) is the response of the IRS, the IRS Oversight Board, and the National Taxpayer Advocate, to a Congressional mandate for developing a five-year plan for taxpayer service. The TAB team supported research that formed the foundation for decisions related to taxpayer service. For a detailed discussion of taxpayer needs and preferences, including findings from several of the TAB research studies, see National Taxpayer Advocate 2006 Annual Report to Congress vol II at 1.

<sup>48</sup> *The Tax Gap: Hearing Before the Subcomm. on Taxation and IRS Oversight of the S. Comm. on Finance*, 109<sup>th</sup> Cong. 2<sup>nd</sup> Sess (July 26, 2006) (testimony of Nina E. Olson, National Taxpayer Advocate).

<sup>49</sup> SB/SE Research, *The Nonfiler Problem- Part II* (Mar. 24, 2006).

<sup>50</sup> IRS, *2007 Taxpayer Assistance Blueprint Phase 2* 53 (April 2007).

## IRS Comments

The IRS appreciates the National Taxpayer Advocate's acknowledgement of our nonfiler efforts. We agree that individuals who do not timely file returns contribute significantly to the tax gap and constitute a significant compliance problem. Our recognition and awareness of the need for greater emphasis in this area was the catalyst for the development of a Servicewide nonfiler plan.

Effectively addressing the nonfiler problem requires a servicewide course of action to maximize the use of available resources. We agree that a balanced strategy of research, service, and enforcement is needed. It is precisely because of these reasons that the IRS has initiated multiple actions to address the nonfiler issue.

The IRS Servicewide Nonfiler Plan evolved from the Nonfiler Summits that focused on the current state analysis by:

- Establishing definitions;
- Describing the domain;
- Setting targets (where do we want to be in 2-5 years);
- Identifying the most critical compliance issues.

Acknowledging the benefits of a servicewide approach, the IRS held the first Nonfiler Summit in 2005, to begin a coordinated nonfiler strategy across all operating divisions (ODs). In 2006, the second IRS Nonfiler Summit focused on the identification of nonfiler issues, solutions, and treatments. In 2007, the IRS developed and implemented a Servicewide Nonfiler Plan. The Collection Governance Council reviewed and adopted the Servicewide Nonfiler Plan as did the OD Commissioners.

In August 2007, the IRS Enforcement Committee approved the Servicewide Nonfiler Plan. The Plan focuses on accomplishing three goals:

- Effectively use enforcement to deter filing noncompliance;
- Help taxpayers understand and meet their filing obligations; and
- Leverage technology to identify nonfilers and remove impediments to filing.

The Plan includes the following initiatives:

- Allocate resources based on a servicewide approach to ensure end-to-end accountability for nonfiler treatment decisions;
- Develop and implement consistent servicewide performance and outcome measures to determine impact on filing compliance;
- Implement a Servicewide Nonfiler Communication Program that includes an internal and external focus to address filing requirements;

- Expand the use of third party information and research tools to enhance identification; selection, and resolution of nonfiler cases.
- Ensure nonfiler cases meeting fraud criteria are referred for civil fraud penalties and/or referred for criminal investigation; and
- Encourage the development and submission of legislative proposals and other regulatory actions to increase filing compliance.

The servicewide Nonfiler Program will be governed by an Executive Advisory Council which will ensure achievement of outcome and performance goals. The Executive Advisory Council includes a representative from TAS.

Another servicewide Nonfiler Summit was held in December 2007. Beginning in 2008, the IRS will align actions and implement the accepted measures. We will also focus and align all FY 2009 work plans on IRS Nonfiler Plan requirements and establish baseline service-wide measures. For 2009 and beyond, we plan to fully implement the Nonfiler Plan.

The National Taxpayer Advocate has emphasized three (3) additional issues impacting filing compliance for the IRS to consider:

- IRS organizational changes impact nonfilers;
- Taxpayer attitudes influence behavior; and
- Compliance risk and associated downstream costs.

### **IRS Organizational Changes Impact Nonfilers**

#### *Default Assessment and TAS Casework*

Default assessments are a by-product of an automated system which attempts to secure compliance from taxpayers who have not responded to notices. While we would prefer that more taxpayers respond to initial notices by voluntarily filing returns or contacting the IRS, we do not agree that default assessments represent a program failure or are inherently ineffective. Furthermore, as the report acknowledges, repeat nonfilers make up a significant portion of the overall nonfiling population, and accordingly have a history of being non-responsive. We also do not agree with the suggestion that dollars collected is the best measure of the effectiveness of these assessments. Each assessment abated or adjusted reflects the submission of a return or other response by the taxpayer after the ASFR default assessment has been made—a clear indication the taxpayer has been successfully brought into compliance.

The low collection figures cited in the report reflect dollars collected on ASFR assessments made in the current year. ASFR taxpayers typically do not pay the tax liabilities in the same year of the assessment. To properly measure program results, the accounts should be tracked over an extended period of time as the percent collected or otherwise resolved will increase over time. For example, as of September 2007, 22 percent of tax year 2002

ASFR default assessments reflect some payment, and 33 percent reflect a payment, credit, or adjustment.

We recognize that TAS casework related to the ASFR program has increased in spite of our improved processes and high quality. Some increased workload was inevitable given the increased size of the program. The ASFR program closed over 1.3 million cases in FY 2007—four times as many as in FY 2004. TAS receipts as a percentage of total ASFR cases have actually declined over this period. The number of ASFR issues received by TAS is less than one percent of the total ASFR cases closed.

The data table with TAS receipts reflects the percentage of cases granted relief by TAS, but does not specify the types of relief requested. Historically, 98 percent of the returns received from taxpayers still reflect a tax liability and result in only a partial abatement of the default assessment. Relief granted in the form of additional time to file, the release of a refund, or the partial abatement of a default assessment would not indicate that the initial assessment was not worthwhile or did not achieve its intended purpose of bringing the taxpayer into compliance.

The ASFR program has numerous controls built in to insure that assessment decisions are reasonable. Prior to the issuance of an ASFR 30 day or 90 day notice, both systemic and manual reviews are performed on the cases to identify bad payer income documents, high dollar (over \$100,000) cases, and accounts where an IRP document has been changed or corrected on master file. The ASFR system has built-in checks that identify cases for manual review when account research indicates that returns, correspondence, or other conditions exist. For those selected for manual review, frontline employees review the cases and make a determination whether the account should be moved to notice status.

In addition, employees are able to make online adjustments when taxpayers call or correspond with pertinent information that results in changes to a proposed assessment. Responses that correct errors in reported income are worked, as is all correspondence, within 30 days of the IRS received date. If the incorrect reported information is not detected in the above reviews, the notices sent to the taxpayer provide the document information used to arrive at the proposed liability. At least eight months will elapse from the issuance of the 30 day letter before a default assessment is made. This provides the taxpayer sufficient time to resolve the issue.

An automated process is essential if the IRS is to adequately address the nonfiler population by handling the greatest number of cases in the most efficient manner possible. The current process prioritizes case selection based on income data from third party information return documents. In FY 2006, the IRS received over 1.5 billion information returns.<sup>51</sup> In FY 2007, ASFR corporately closed 1.36 million cases.

<sup>51</sup> IRS Data Book, *Table 14 Information Reporting Program (FY 2006)*.

Although personal contact prior to notice issuance is not a viable alternative, there are various options available to promote dialogue with the taxpayer. ASFR provides a toll-free number on the notices. The ASFR Toll Free site is staffed by a dedicated team of employees specifically trained to handle telephone contacts. Universal access provides all ASFR employees with the capability of accessing database information to respond to taxpayer inquiries, regardless of case control or originating site of assessment. Additionally, if a taxpayer submits correspondence about a notice, IRS employees working ASFR cases are directed to attempt to contact the taxpayer by phone at least twice before providing a written reply.

### ***Taxpayer Assistance Centers (TAC)***

The IRS agrees that more can be done to educate and assist taxpayers in meeting their filing requirements, and that requiring taxpayers to visit a TAC on multiple occasions in order to have their return prepared is placing undue burden on our customers. We plan to place greater emphasis on providing both current and prior year return preparation services. Thus, when taxpayers qualify and have all the necessary documents with them, and where employees are trained and there is capacity, we will prepare the taxpayers' current and prior year returns at the same time.

The Field Assistance business practice is to address filing compliance with our customers and when customers are found not to be in compliance, our employees advise the customer of their filing requirement and the possible consequences of not filing a return. Customers are also advised of the various means to receive assistance in filing those returns, including being provided with a return preparation appointment if they qualify. Unfortunately, we recognize that not all customers qualify for this service and we will continue to balance the three product lines for return preparation including free-file, Volunteer Income Tax Assistance (VITA), and Low Income Taxpayer Clinics (LITC).

### **Taxpayer Attitudes Influence Behavior**

The IRS agrees that more research is needed in this area and additional research activities are planned as part of our servicewide Nonfiler Plan. A number of actions included in the Plan focus on education, testing and outreach to better assess factors that contribute to nonfiling. The IRS's vision statement, as outlined in the Plan, also calls for the IRS to "reduce the number of chronic nonfilers by partnering with external sources to develop and implement effective outreach actions and by effectively allocating compliance resources." Goal two of the Plan is, "Help taxpayers understand and meet their filing obligations." These combined actions will not only help the IRS to better understand taxpayer behavior, but also target our treatment streams more effectively.

### **Compliance Risk and Downstream Costs are High**

The IRS agrees that resources and enforcement efforts should be applied to those areas with the highest compliance risk. Our processes are designed to identify and target high risk areas, and we agree that enforcement activity concerning nonfilers should be directed

to those with a balance due. Accordingly, one of the key initiatives included in our service-wide Nonfiler Plan is allocation of resources based on a servicewide approach to ensure end-to-end accountability for nonfiler treatment decisions. Specific supporting actions include:

- Initiating expansion of Consolidated Decision Analytics (CDA) models to direct treatments. The purpose of CDA is to provide an enhanced Inventory Delivery System (IDS) which incorporates modernized predictive data analysis technology to support the collection process for all of IRS. CDA implementation will allow for improved routing and treatment of collection cases. Activities of both ACS and Collection Field function (Cff) can be better aligned with the appropriate type of case assignment and the improved case coverage;
- Expanding the use of Combined Annual Wage Reporting (CAWR) from the CAWR program (Reporting Compliance) for use in the A6020b program (Filing Compliance);
- Implementing the Business Master File (BMF) Case Creation Nonfiler Identification Process (CCNIP) in FY 2008. The purpose of this action is to improve the quality of BMF nonfiler workload selections; and
- Using a specialized hybrid site to work complex nonfiler cases. Two test sites have been identified. These sites will use existing resources including the combined collection skills of ACS employees, COIC employees and revenue officers. Nonfiler cases that are currently in the Cff queue or have not been worked in ACS due to other priorities will be issued and worked as part of this test.

Concerning the recommendation to measure the cost of downstream consequences in relation to return on investment, the impact of compliance activities does not lend itself to traditional revenue-estimating analysis, and it is difficult to quantify the effect that such activities have on taxpayer behavior. We agree that measures are a necessary component of an effective program. However, as the IRS, the National Taxpayer Advocate, and the Oversight Board have jointly recognized<sup>52</sup>, accurate and relevant measures of the effectiveness of compliance activities can be difficult to define.

In summary, the IRS's goal is to implement a comprehensive, effective and balanced nonfiler program in accordance with the timeframes set forth in the servicewide Nonfiler Plan. We welcome the National Taxpayer Advocate's input and participation in this initiative.

<sup>52</sup> IRS, *Taxpayer Assistance Blueprint Overview Executive Summary* (July 19, 2007)



## Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS is taking steps to address nonfilers using a servicewide approach, but is concerned that its planned actions for research, service, and enforcement are not well balanced. The servicewide Nonfiler Plan is heavily geared toward enforcement. The IRS needs to apply more resources to identify reasons *why* taxpayers do not file returns and investigate ways to change filing behavior. For example, if IRS research finds that taxpayers fear criminal sanctions after not filing for several years, the IRS needs to openly state its policy of generally not pursuing criminal fraud when taxpayers voluntarily come forward and file accurate returns.<sup>53</sup> We are very pleased that IRS is now preparing current and prior year returns in Taxpayer Assistance Centers (TAC) without taxpayers having to visit the TAC first for an appointment. In addition, the IRS needs to provide taxpayers with alternative tax preparation resources in a neutral setting. For example, taxpayers who fear the IRS may be willing to visit a VITA site or corporate partner in lieu of an IRS office to have returns prepared. Moreover, National Filing Days, in which the IRS and volunteers not only file returns but also help taxpayers resolve balances due on those returns, will send a clear message to taxpayers that the IRS wants to help them return to compliance.

### *IRS Organizational Changes Impact Nonfilers*

The traditional IRS approach to promote filing compliance and secure delinquent tax returns relies on techniques that minimize human involvement and therefore fail to provide the IRS with detailed feedback on why taxpayers do not respond to contacts or file returns. The IRS needs to research the underlying causes of delinquencies and develop new approaches for nonfilers.

### *Default Assessments and TAS Casework*

The National Taxpayer Advocate disagrees with the IRS that Automated Substitute For Return (ASFR) default assessments are effective in improving filing compliance. While it is true that repeat nonfilers are a significant portion of the nonfiler population, the IRS does not know whether these taxpayers are truly non-responsive, or whether the IRS systems and processes failed them. For example, if the IRS does not utilize external locator services or the Internet to search for a current address, it does not know if the taxpayer actually received notices. The IRS needs to look behind the default numbers before concluding that an abated assessment, or the submission of a return subsequent to a default assessment, is a clear indication that the taxpayer was successfully brought into compliance. A true indication that a taxpayer is in filing compliance is future filing behavior, which the IRS does not track.

The National Taxpayer Advocate urges the IRS to research why ASFR assessments result in dismal collection. The IRS agrees that collections are extremely low in the year of the

<sup>53</sup> IRM 4.19.17.1 (4) (Nov. 10, 2006).

assessment, and only 22 percent of tax year 2002 ASFR default assessments reflect *some* payment by September 2007. These figures are disturbing and should be researched in relation to the ASFR process.

TAS casework continues to increase as the ASFR program expands. Because taxpayers often contact TAS many months after ASFR closure when collection actions occur, the IRS estimate of the percentage of TAS cases to ASFR closures in a given year is not a valid comparison. TAS case advocates assist taxpayers with ASFR assessments and obtain relief for erroneous assessments. The IRS should research why taxpayers do not respond to ASFR notices and improve the automated process before significantly expanding the program, given its high default rate, low collection rate, and generation of significant TAS casework.

#### *Taxpayer Assistance Centers*

As noted earlier, the National Taxpayer Advocate commends the IRS plans for expanding both current and prior year return preparation services in the Taxpayer Assistance Centers. In addition to promoting the Free-file program, VITA, and LITCs (which primarily provide tax return assistance in the context of tax controversies), the IRS should work with corporate partners and community groups to offer National Filing Days.

#### *Taxpayer Attitudes Influence Behavior*

The National Taxpayer Advocate supports the IRS plan to conduct additional research to better understand taxpayer behavior. Through research, the IRS will capture relevant behavioral data and develop strategies to promote filing compliance. For example, early intervention with a soft notice may be very helpful. The largest category of nonfilers is first-time nonfilers. What causes the repetitive behavior? Fear? Would additional soft notices encourage these taxpayers to file? Would National Filing Days? Are certain types of life events conducive to repeat nonfilings while others lend themselves to only one year of nonfiling? Such information would help the IRS craft messages to the taxpaying public and perhaps help bring taxpayers in, or reassure them that they can contact the IRS or respond to the notices.

#### *Compliance Risk and Downstream Costs are High*

The IRS plan for detecting nonfilers with the highest compliance risk, using predictive data analysis, should improve case selection and minimize the burden on taxpayers with little or no tax due. The National Taxpayer Advocate recommends that the IRS perform “sanity checks” on any case selection model, however, to ensure that unnecessary compliance contacts do not needlessly burden or harm taxpayers.

The National Taxpayer Advocate appreciates the invitation to participate on the IRS Executive Advisory Council to weigh in on proposed nonfiler initiatives that impact taxpayer rights and burden. TAS representation at the Nonfiler Summit and participation in discussions on proposed initiatives benefits both the IRS and taxpayers. To improve filing

compliance the IRS needs to balance service and enforcement priorities, by understanding the reasons for nonfiling and crafting its remedies in light of that knowledge.

## Recommendations

The National Taxpayer Advocate recommends the IRS take the following steps:

- Conduct behavioral research to assess filing compliance risks of differing taxpayer segments and develop strategies for each segment.
- Launch a public information campaign to remind taxpayers of what taxes are really about: the price we pay for a civilized society;
- Develop a tax course for high school students that promotes financial literacy and tax responsibility;
- Establish measurable achievements such as number of returns filed, recidivism rate, and the effects of outreach and education efforts on filing compliance;
- Establish a compliance file marker to identify single year and repeat nonfilers, skip filers, and stop filers who may require different treatments to increase filing compliance.
- Re-establish and promote National Filing Days to assist taxpayers with delinquencies;
- Establish more corporate partnerships through W&I (SPEC) so large employers provide free tax return preparation for their low income, disabled, elderly, and limited English proficiency (LEP) employees;
- Initiate more partnerships with industry groups that have filing compliance issues and develop strategies to increase compliance;
- Enhance data sharing with states when they issue business and professional licenses. Mail new businesses a “welcome packet” that describes their obligations and provides a contact number for questions;
- Mail “soft” notices to delinquent taxpayers and remind them of their obligations as well as the opportunity to file without significant consequences, and provide a contact number;
- Rigorously pursue intentional nonfilers and promoters who undermine the tax system and widely publicize convictions as a deterrent to others; and
- Pursue authority for voluntary withholding agreements between independent contractors and service recipients, which will address one of the causes for nonfiling, namely the inability to pay tax due on the return.<sup>54</sup>

<sup>54</sup> For a detailed discussion of this recommendation see Most Serious Problem, *Cash Economy, infra/supra*.

**MSP  
#17****Automated Underreporter****Responsible Officials**

Richard J. Morgante, Commissioner, Wage and Investment Division

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division

**Definition Of Problem**

The IRS's Automated Underreporter (AUR) program matches payments reported to IRS by employers, banks, and other third parties with the actual income reported on an individual's tax return. A potential AUR case exists when these two items do not match. Although automation has allowed the IRS to more efficiently identify and determine when such underreporting occurs, the IRS's over-reliance on automated systems rather than personal contact has led to insufficient levels of customer service for taxpayers subject to AUR. It has also resulted in audit reconsideration and tax abatement rates that are significantly higher than those of all other IRS examination programs.<sup>1</sup>

The National Taxpayer Advocate has identified aspects of the AUR system that appear to contribute to the high abatement rate in AUR cases. The system often fails to:

- Respond timely to taxpayer correspondence or handle toll-free calls;
- Effectively analyze reported income; and
- Provide clear direction to taxpayers on how to resolve AUR cases.

**Analysis of The Problem****Background**

The IRS's intention when automating the AUR system was to help taxpayers receive more accurate, timely, and personalized notices, which in turn would allow for quicker and more consistent responses to the taxpayers' inquiries. Automation is reasonable given the volume of Information Return Processing (IRP) documents the IRS receives.<sup>2</sup> However, some AUR notices are now completely automated, with no examiner screening the cases before

<sup>1</sup> Consider the following data for fiscal year (FY) 2003 to FY 2006 abatement rate ranges: AUR, 88 percent to 91 percent; Area Office, 41 to 53 percent; Appeals, 28 to 46 percent; Automated Substitute for Return (ASFR), 14 to 38 percent; and Remote Exam, 49 to 53 percent. IRS, *Enforcement Revenue Information System Summary Database* (Apr. 2007).

<sup>2</sup> IRS, *Calendar Year Projections of Information & Withholding 2007-2015*, 2006; Office Of Research, *Historical Figures of IRP Documents* (1,549,714,235) (July 23, 2007); available at [http://research.web.irs.gov/RAS/Projections\\_&\\_Forecasting/publications\\_produced\\_by\\_p&f\\_group.asp#Document%206961](http://research.web.irs.gov/RAS/Projections_&_Forecasting/publications_produced_by_p&f_group.asp#Document%206961).

the notices go out.<sup>3</sup> Automation has increased efficiency in identifying underreporting of income, but over-reliance on automation has also led to a lack of quality customer service for taxpayers and created a higher rate of audit reconsiderations and abatement of tax than exists in other IRS examination functions.<sup>4</sup>

The advent of AUR toll-free telephone service in 2001 was designed to give taxpayers an avenue for resolving AUR issues.<sup>5</sup> However, both the Wage and Investment (W&I) and Small Business/Self-Employed (SB/SE) divisions have recorded comparatively low Levels of Service<sup>6</sup> for the AUR toll-free product line. This situation has not only prompted complaints from taxpayers and practitioners but has also raised concerns from the Treasury Inspector General for Tax Administration (TIGTA) about whether AUR toll-free service is as effective as it should be.<sup>7</sup>

When the AUR system detects unreported income, it sends a letter of proposed assessment (known within the AUR program as the CP 2000 notice), giving taxpayers 30 days from the date of the notice to respond with any reason why IRS should not assess the additional tax.<sup>8</sup> If taxpayers do not respond or the IRS fails to process their response within the required period, the IRS issues a Statutory Notice of Deficiency, giving the taxpayers 90 days to file a petition with the U.S. Tax Court.<sup>9</sup> If the taxpayer does not file a petition, the tax is assessed after the 90 day period has expired.<sup>10</sup> The taxpayer's only administrative recourse is to contest the assessment by asking the IRS to reexamine the assessment (known within the IRS as an "audit reconsideration"). This is done by filing an amended return or requesting a reconsideration of the assessment through written correspondence.<sup>11</sup>

Too often, AUR procedures fail to address taxpayers' responses to AUR inquiries, whether written or through toll-free telephone lines. TAS receives a large volume of AUR-related contacts from taxpayers and practitioners. In fiscal year (FY) 2006, TAS received 12,424 cases where the primary issue involved AUR. This figure rose to 13,770 cases in FY 2007.<sup>12</sup>

<sup>3</sup> IRM 4.19.3.1 (Sept. 1, 2005): Beginning in tax year 2003, the system automatically generates CP 2000 notices for select income categories. This notice is a prelude to a Statutory Notice of Deficiency and provides an overview of the proposed tax assessment.

<sup>4</sup> Consider the following data for FY 2003 to FY 2006 abatement rate ranges: AUR, 88 percent to 91 percent; Area Office, 41 to 53 percent; Appeals, 28 to 46 percent; Automated Substitute for Return (ASFR), 14 to 38 percent; and Remote Exam, 49 to 53 percent. IRS, *Enforcement Revenue Information System Summary Database* (Apr. 2007).

<sup>5</sup> General Accounting Office, GAO/GGD-94-159, *Automated Underreporter Project 28* (July 1994).

<sup>6</sup> Level of Service is the measure of the relative success of a customer seeking service or receiving service from a toll-free assistor.

<sup>7</sup> Treasury Inspector General for Tax Administration, Ref. No. 2006-40-138, *The Wage and Investment Division Automated Underreporter Telephone Operations Could Improve Service to Taxpayers* (Sept. 13, 2006).

<sup>8</sup> IRM 4.19.3.20.8 (Apr. 6, 2005).

<sup>9</sup> IRC §§ 6211 & 6216.

<sup>10</sup> IRM 4.19.2.3.9 (Sept. 1, 2003); IRM 4.19.2.3.10 (Sept. 1, 2003).

<sup>11</sup> IRM 4.19.3.24.4 (Sept. 1, 2004). An AUR reconsideration is a process where the IRS reconsiders the validity of a prior tax assessment. This provides the taxpayer an opportunity to present information previously *not* considered during the original audit.

<sup>12</sup> IRS, *Business Performance Management System*, available at [http://bpms.web.irs.gov/decweb/bpms/home/\\_asp/trMain2.asp?App=BPMS\\_new&Cat=Taxpayer+Advocate+Service&Hide=NO&Reload=No](http://bpms.web.irs.gov/decweb/bpms/home/_asp/trMain2.asp?App=BPMS_new&Cat=Taxpayer+Advocate+Service&Hide=NO&Reload=No).

Cases generated in AUR incur high rates of default assessments, high rates of reconsideration requests, and even higher rates of abatement of those reconsiderations.<sup>13</sup> Table 1.17.1 reflects AUR for Statutory Notices of Deficiency issued, default assessments, and reconsiderations as reported by W&I and SB/SE for FY 2006 and FY 2007.<sup>14</sup>

**TABLE 1.17.1, AUR Default Assessments**

	FY 2006	FY 2007
Statutory Notices Issued	2,980,619	3,340,951
Default Assessments	1,752,841	2,145,715
Rate of Default Assessments	59%	64%
Reconsiderations Processed	247,020	254,944
Rate of Reconsiderations Relative to Defaults	14%	12%

Table 1.17.1 shows that in FY 2006 over 59 percent of the AUR Statutory Notices of Deficiency issued ended up in a default assessment. This rate has increased to over 64 percent for FY 2007. The default rate, coupled with the high rate of abatements in AUR reconsideration cases, suggests systemic problems in the AUR processes. Tables 1.17.2 and 1.17.3 reflect the abatement rate<sup>15</sup> and the amounts received by taxpayers who seek audit reconsideration from AUR assessments.<sup>16</sup>

**TABLE 1.17.2, AUR Abatement Rates**

FY Closed	Abatement Requests	Number of Assessments Abated	Percentage of Assessments Abated
2003	76,496	69,484	91%
2004	77,947	69,880	90%
2005	88,562	77,507	88%
2006	95,682	84,141	88%

**TABLE 1.17.3, AUR Abatement Amounts**

FY Closed	Original Tax Assessment	Average Tax Assessment	Average Abate Amount	Total Abate Amount
2003	\$300,874,709	\$3,933	\$3,405	\$236,591,714
2004	\$357,519,622	\$4,587	\$3,945	\$275,689,505
2005	\$593,762,689	\$6,704	\$6,341	\$491,451,126
2006	\$652,771,603	\$6,822	\$6,340	\$533,416,925

<sup>13</sup> IRS, Enforcement Revenue Information System Summary Database (Apr. 2007).

<sup>14</sup> Wage & Investment Division Reporting Compliance, *Automated Underreporter Reports*, at [http://pmaq.web.irs.gov/Compliance\\_PMAQ\\_AUR.htm](http://pmaq.web.irs.gov/Compliance_PMAQ_AUR.htm); SB/SE COBR report.

<sup>15</sup> The Enforcement Revenue Information System (ERIS) is reviewing its programming to determine if all AUR reconsiderations are included in the system.

<sup>16</sup> IRS, Enforcement Revenue Information System Summary Database (Apr. 2007).

As Table 1.17.3 indicates, from FY 2003 through 2006 the abatement rate for AUR cases in audit reconsideration ranged from 88 to 91 percent. For FY 2006, taxpayers received an abatement of 82 percent of the amount the IRS originally assessed.

There are several aspects of the AUR system that appear to contribute to the high AUR abatement rate. AUR fails to:

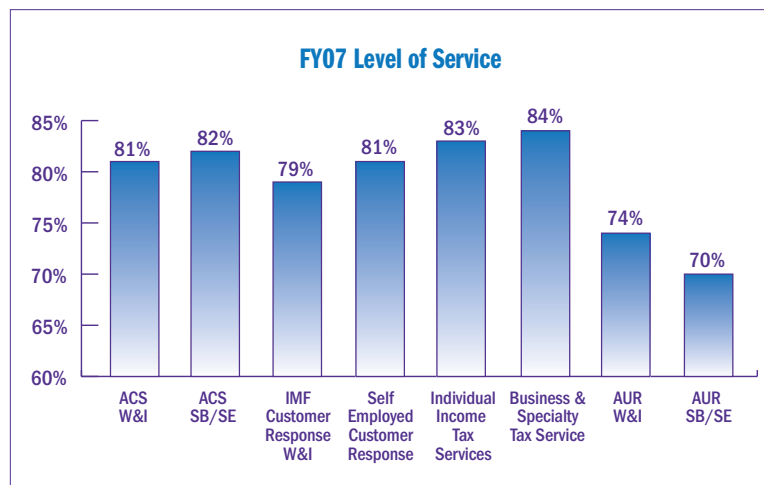
- Respond timely to taxpayer correspondence or handle toll-free calls;
- Effectively analyze reported income during the automated and manual screening process, thereby creating unnecessary burden for the taxpayer; and
- Provide clear direction to taxpayers on how to respond to resolve their AUR cases.

**Failure to Address Taxpayer Responses to AUR Proposed Assessments**

*Toll-Free Phone Service*

IRS guidelines require that AUR case processing be suspended in situations where the taxpayer has contacted the IRS through correspondence to allow the IRS time to evaluate taxpayers’ submissions prior to issuing a Statutory Notice of Deficiency or making the proposed tax assessment.<sup>17</sup> The IRS appears to presume that taxpayers who reach a customer service representative on the phone will receive immediate and comprehensive service. However, the Level of Service (LOS) for the AUR toll-free program does not justify such a presumption.<sup>18</sup> As shown in Table 1.17.4, SB/SE’s AUR toll-free operation answered only 70 percent of calls received in FY 2007, while W&I answered only 74 percent.

**CHART 1.17.4, AUR Toll-Free Customer Service Data**



<sup>17</sup> IRM 4.19.3.24.2 (Sept. 1, 2006) and IRM 4.19.3.24.4 (Sept. 1, 2004).

<sup>18</sup> Level of Service for AUR is defined as calls handled divided by CSR attempts (Calls handled = calls handled by examiners + calls handled by informational announcements, CSR attempts = calls handled + secondary abandons + VCR busies + VCR courtesy disconnects + emergency closed + calculated network incompletes). SB/SE, AUR Snapshot Guidelines, available at [http://joc.enterprise.irs.gov/new/josh/reports/wits/2003/SBSE%20AUR\\_Snapshot.xls](http://joc.enterprise.irs.gov/new/josh/reports/wits/2003/SBSE%20AUR_Snapshot.xls),



In FY 2006, the levels of service for SB/SE and W&I were even lower, at 69 percent and 64 percent respectively.<sup>19</sup> As the table shows, the overall LOS for AUR toll-free is lower than for all other IRS toll-free lines. TIGTA suggested that W&I increase its target level to be more in line with others but the IRS refused to implement the recommendation, indicating that less should be expected from AUR since its employees are also required to handle and respond to taxpayer correspondence.<sup>20</sup> This response seems to fall short, however, because other IRS toll-free operations are also driven by notice and taxpayer written responses.

In response to complaints from Local Taxpayer Advocates (LTAs), practitioners, and taxpayers, TAS reviewed a statistically valid sample of calls coming into the AUR toll-free service through the IRS's Contact Recording System.<sup>21</sup> The review revealed that the AUR toll-free line seldom succeeds in resolving taxpayers' issues. Of the 400 calls reviewed, only seven percent led to a case closure. In seven percent of the cases, the assistor did not obtain or verify the taxpayer's Social Security number as standard IRS telephone procedure requires.<sup>22</sup> In 21 percent of the calls reviewed, the taxpayer had already replied to the AUR notice and had either not received any response or had received a notice of deficiency or an interim letter requesting even more time for AUR to analyze the taxpayer's response, all without case resolution.<sup>23</sup>

### *Taxpayer Correspondence*

The IRS does not always process taxpayers' written replies to AUR notices quickly enough to prevent the taxpayer from receiving a notice of deficiency or subsequent default assessment. If the taxpayer chooses not to pursue court action against the government, his or her only recourse is to seek reconsideration of the AUR assessment, an action which often leads the IRS to abate the assessment. As Table 1.17.2 above illustrates, the average abatement rate for AUR cases in audit reconsideration was 89 percent for FY 2003 through FY 2006.<sup>24</sup> Such a high percentage of abatements in audit reconsideration suggest the IRS is expending an unnecessary amount of resources and needlessly occupying the time and resources of the taxpayer in the AUR program.

The effort expended by both the IRS and taxpayer could be avoided if the IRS properly handled the initial taxpayer contact. A review of the aged correspondence from taxpayers

<sup>19</sup> IRS, Enterprise Telephone Data Reporting, *Snapshot Reports, Product Line Detail (Sept. 30, 2007)* at <http://joc.enterprise.irs.gov/etd/>.

<sup>20</sup> Treasury Inspector General for Tax Administration, Ref. No. 2006-40-138, *The Wage and Investment Division Automated Underreporter Telephone Operations Could Improve Service to Taxpayers* (Sept. 13, 2006).

<sup>21</sup> Contact Recording is a tool that records incoming calls for required random review (performance and product). The system provides for screen-capture of e-case work and the actions taken simultaneously with the voice recording. The data is stored by employee Standard Employee Identifier (SEID) for a minimum of 45 days. See IRM 3.42.7.7.9 (Apr. 12, 2007).

<sup>22</sup> IRM 4.19.3.20.2.2 (May 4, 2007). AUR contact recording review sample data was weighted in accordance with the population represented by each strata. Accordingly, at the 95 percent confidence level between four percent and ten percent of calls led to a case closure and between four percent and ten percent of assistors did not obtain or verify the taxpayer's Social Security number.

<sup>23</sup> AUR contact recording review at the 95 percent confidence level revealed that between 17 percent and 25 percent of taxpayers had already replied to the AUR notice.

<sup>24</sup> IRS, *Enforcement Revenue Information System Summary Database* (Apr. 2007).

over the same period may offer a partial explanation for the high abatement rate, *i.e.*, the IRS is not processing correspondence in a timely fashion.<sup>25</sup> When the AUR program fails to analyze correspondence, it may issue inaccurate Statutory Notices of Deficiency and tax assessments, forcing the taxpayer to seek audit reconsideration. Table 1.17.5 indicates an unacceptable volume of AUR correspondence is overage, *i.e.* the taxpayers' issues have not been addressed or resolved within the prescribed time.<sup>26</sup>

**TABLE 1.17.5, AUR Aged Correspondence**

	FY 2006	FY 2007
W&I Correspondence Inventory	85,821	101,754
W&I Correspondence Aged beyond 30 days	38%	36%
SB/SE Correspondence Inventory	30,420	20,239
SB/SE Correspondence Aged beyond 30 days	6%	20%

As the table shows, W&I correspondence age has improved since September 30, 2006, but still remains below the established level.<sup>27</sup> The lack of emphasis on processing taxpayer responses is best demonstrated for SB/SE, where the aged percentage has increased substantially.<sup>28</sup>

**AUR systems do not accurately analyze income during the automated and manual screening process, thereby creating unnecessary burden for the taxpayers.**

AUR determinations about the taxable nature of income are only as accurate as the information fed into the IRS's data systems. However, these systems do not capture all the available information, with the consequence of incomplete records and unnecessary burden to the taxpayer. As the following example illustrates, the IRS does not always possess the same detailed information that is on taxpayers' Forms 1099, U.S. Information Return.

**EXAMPLE:** Through her broker, a taxpayer engaged in a short sale, which occurs when a taxpayer sells property (usually stock) that he or she does not own by borrowing property and delivering it to a buyer. The taxpayer later closes the sale by replacing the property with the lender, and does not realize gain or loss until the closure.<sup>29</sup> In this case, the short sale was non-taxable in the year the return was filed. The taxpayer received a Form 1099-B indicating the transaction was not taxable, but IRS systems do not capture that type of detail. As a consequence, the

<sup>25</sup> See IRM 3.0.273.19.4 (Jan. 1, 2007) which states that Action 61 Guidelines require all correspondence be processed within 30 days.

<sup>26</sup> IRS, *Business Performance Management System, Snapshot data for Sept. 30 dates*, at <http://bpms.web.irs.gov/decweb/bpmshome/Bpms1Main.asp>.

<sup>27</sup> W&I AUR operating guidelines for FY07 direct the sites to adhere to the procedural requirements for the timely controlling of correspondence; per Action 61 Guidelines (procedural requirements) all correspondence should be processed within 30 days. IRM 3.0.273.19.4 (Jan. 1, 2007). SB/SE guidelines established the aged goal at ten percent indicating no more than ten percent of cases should be over 30 days old.

<sup>28</sup> SB/SE response to TAS information request (Nov. 2, 2007).

<sup>29</sup> See IRS Pub. 550, *Investment Income and Expenses*.

AUR picked up the short sale as a taxable transaction and proposed adjustments to the taxpayer's account. The taxpayer provided the IRS with a copy of the Form 1099-B, which led to a favorable determination.

Even though this taxpayer successfully resolved her case, the example helps demonstrate the limitations of AUR systems. The IRS should either work the more complicated taxpayer transactions outside the AUR program or upgrade its systems to capture and analyze all the details of transactions for which it will hold the taxpayer liable.

The AUR process also assumes income is not reported even when the taxpayer may report it on another line of the return.<sup>30</sup> AUR tax examiners review the returns but do not always detect misplaced entries. The IRS then sends an unnecessary notice to a taxpayer who is otherwise compliant, incurring unnecessary costs and wasting time for its own employees and the taxpayer.

**EXAMPLE:** An AUR taxpayer receives a CP 2000 notice indicating failure to report specific income. The taxpayer contacts AUR through the toll-free line and informs the assistor the income was reported on line 21, *Other Income*, on the Form 1040. The case is then closed.<sup>31</sup>

In this case, the IRS already had the information needed to ascertain that the taxpayer did in fact report the income in question without subjecting the taxpayer to the AUR process. The IRS could enhance the AUR systemic process to validate all income reported from the total of line 22, *Total Income*, on Form 1040; line 15, *Total Income*, on Form 1040A; and line 4, *Adjusted Gross Income*, on Form 1040EZ when comparing information returns to tax returns and more accurately determining underreporting of income.

**The AUR CP 2000 notice is lengthy and confusing, causing further taxpayer contact for an overburdened toll-free process.**

The AUR CP 2000 notice is confusing and can be intimidating due to its length (ten pages). This was evident during the AUR toll-free review, where 23 percent of the callers were seeking an explanation of the notice.<sup>32</sup> The perception of taxpayers' confusion with the notice was confirmed by their responses to a customer satisfaction survey for AUR toll-free lines.<sup>33</sup> The IRS should seek to clarify the CP 2000 instructions to ensure taxpayer compliance from the outset.

<sup>30</sup> IRM 4.19.3.4.2 (May 4, 2007).

<sup>31</sup> National Taxpayer Advocate review of AUR Contact Recordings.

<sup>32</sup> *Id.* The review found that at the 95 percent confidence level, between 20 and 26 percent of callers were seeking an explanation of the notice.

<sup>33</sup> Pacific Consulting Group, *Automated Underreporter SB/SE National Report*, covering Jan. through Mar. 2007 at 6 and 12 (Aug. 2007).

For example, the CP 2000 instructs the taxpayer not to file an amended return in response to the notice,<sup>34</sup> but advises the taxpayer to file amended returns for any prior or subsequent tax year in which the same error may have occurred.<sup>35</sup> Depending on the taxpayer's circumstances, however, filing an amended return for the CP 2000 year may be in the taxpayer's best interest.

Also, a taxpayer may have elected to take the standard deduction. After having additional income attributed to the taxpayer, it may be in his or her best interest to itemize. The CP 2000, however, informs the taxpayer not to file an amended return for the year at issue, leaving the taxpayer unable to use credits or deductions properly allowed. Notwithstanding the IRS's instructions, the AUR program has procedures in place to deal with amended returns from taxpayers in the program.<sup>36</sup> The IRS should thus inform taxpayers whose circumstances may be similar to the example above that they can file amended returns to fully utilize their credits and deductions.

The IRS has taken steps to improve its AUR notices. For example, W&I AUR conducted a series of "soft notice" tests to determine if low dollar potential AUR cases could be worked more effectively in an alternative treatment rather than through regular AUR processing.<sup>37</sup> The tests demonstrate that soft notices can be effective in certain circumstances. The initial test, in 2005, included 500 taxpayers and the 2006 test included 2,005 taxpayers. The results of the tests reflected that 25 percent of taxpayers filed amended returns to correct their underreporting. In addition, only 12.7 percent of the taxpayers included in the tests made telephone contact, indicating the recipients of the notice understood what steps were required. *Moreover, 78 percent of taxpayers receiving soft notices corrected their compliance problem in the next year.* Since only 4.5 million of the 15 million cases with potential income mismatches are selected to be worked in AUR, soft notices may be an effective tool for those taxpayers whose case might not otherwise move through the normal AUR process.<sup>38</sup>

## Conclusion

By improving its customer service and data systems (or alternatively, removing from the AUR certain complex transactions that the systems cannot correctly analyze), the IRS could eliminate unnecessary burden on taxpayers and improve its own efficiency. Incorrect IRS notices cost taxpayers unnecessary time and money and increase IRS toll-free contacts. Poor customer service compounds the burden. The toll-free aspect of AUR needs improve-

<sup>34</sup> The CP 2000 includes the following instruction: "Do not file an amended federal return for the tax year shown in the upper right hand corner of page 1. We will correct this tax year when we receive your response."

<sup>35</sup> CP 2000 Section 3, item 2 states, "File amended returns for any prior or subsequent tax year in which the same error occurred. You'll limit the penalty and interest you owe."

<sup>36</sup> IRM 4.19.3.20.1.17 (Sept. 1, 2005)

<sup>37</sup> A soft notice is considered a noncompliance tool that is short and general, such as a reminder. The AUR soft notice is two pages and advises taxpayers IRS review of their return found a difference in the income reported and income filed and an amended return should be filed to correct the situation.

<sup>38</sup> Commissioner's Enforcement Matters Briefing, *AUR Soft Notice Test Results* (May 2007).

ment, and the IRS should adopt TIGTA's suggestions for increased Level of Service.<sup>39</sup> The failure of these three aspects of the AUR process not only encourages but ensures high volumes of AUR reconsiderations and subsequent abatements in the AUR program.

### IRS Comments

The Automated Underreporter (AUR) Program is one of the most effective and efficient compliance programs in the IRS. It is also a critical component in efforts to address the nation's tax gap. In FY 2007 alone, AUR closed more than 4.5 million cases (TY 2003 – TY 2005) and assessed \$5.1 billion.

The IRS is pleased that the National Taxpayer Advocate recognizes that automation has allowed the IRS to more efficiently identify and determine when situations of underreporting occur. Since automating the program in 1992, AUR has experienced a steady growth in productivity. The IRS has also taken several steps to improve customer service, including the redesign of the CP 2000 and the implementation of corporate call routing. The redesigned CP 2000 received three awards in recognition of efforts to improve notice clarity. The implementation of corporate call routing expanded the AUR toll-free telephone system hours of operation and assistor availability nationwide.

### Automated Notices, Default Assessments, and Abatement Rates

The AUR program systemically matches amounts reported on individual tax returns to what was reported by third parties. Mismatches identified through this process become available AUR inventory. Over 95 percent of cases selected from the available inventory are then individually reviewed by AUR tax examiners. During this process, tax examiners thoroughly review the entire return for misplaced entries to prevent issuing notices in error.

The National Taxpayer Advocate's report states that some AUR notices are completely automated, with no examiner screening before the notices go out. It is true that a very small percentage of AUR notices are generated automatically without employee screening when the historical screen-out rate for these kinds of underreported items is five percent or less. Of the 3.3 million total AUR notices issued for tax year (TY) 2005 in FY 2006, only 146,000, or 4.4 percent, were issued automatically. The National Taxpayer Advocate was briefed on this procedure prior to its implementation and agreed that due to the extremely low screen-out rate, the use of tax examiner resources to manually screen these cases was not warranted. However, even when we send out an automatic notice, taxpayers still have nearly six months to send in any documentation to dispute the underreported items.

The National Taxpayer Advocate's report states that cases generated in the AUR program incur high rates of default assessments. This conclusion is derived by dividing the number

<sup>39</sup> Treasury Inspector General for Tax Administration, Ref. No. 2006-40-138, *The Wage and Investment Division Automated Underreporter Telephone Operations Could Improve Service to Taxpayers* (Sept. 13, 2006).

of AUR statutory notices issued by the number of default assessments. However, most cases in the AUR program do not result in issuance of a statutory notice of deficiency. A more accurate assessment of the default rate can be derived by dividing the total number of AUR notices issued for a given tax year by the number that result in a default assessment. When viewed from this more accurate AUR program-wide perspective, the default rate for notices issued for TY 2002-2004 averages only 15 percent.

With regard to abatement requests, it is important to note that a majority of taxpayers make such requests only after the default assessment. This means that during the six month timeframe before default assessment they either did not respond or they did not provide adequate documentation. Once the tax is assessed, many taxpayers with adequate documentation are motivated to respond and request abatement. The data included in the National Taxpayer Advocate's report that are characterized as the AUR abatement rates are computed by dividing the number of abatement requests by the number of abatements granted. However, this does not take into account the vast majority of AUR cases resolved prior to default assessment. A more accurate measurement of the abatement rate can be derived by dividing the total number of AUR cases closed by the number of abatement requests granted. When viewed from this more accurate program-wide perspective, the abatement rate is actually less than two percent.

### **Taxpayer Responses to AUR Proposed Assessments**

The National Taxpayer Advocate cites a Treasury Inspector General for Tax Administration (TIGTA) report to suggest the IRS needs to increase the level of service for the AUR toll-free lines. As noted in the IRS response to TIGTA, AUR is not exclusively, or even primarily, a telephone program. Of the 75 percent of taxpayers that respond to AUR notices, well over half choose to do so by correspondence. As a result, unlike other IRS telephone operations, such as Accounts Management toll-free, that are primarily devoted to telephone service, AUR must balance the level of service of its telephone operations with the needs of the majority of taxpayers that prefer to respond in writing. However, as acknowledged in the TIGTA report, the IRS has taken a number of steps to improve AUR telephone operations. These include:

- Universal Call Routing – Calls are now routed to any of the three W&I AUR sites based on the availability of assistors. Prior to January 2006, calls were handled at each AUR site based on the area code of the incoming call. Assistor availability and specific hours of operation at each call site limited taxpayer access. The Universal Call Routing system expanded the AUR toll-free telephone system hours of operation and assistor availability nationwide.
- Updated Automated Menus and Messages – In FY 2005, IRS began working to improve the information provided to taxpayers using the automated information on their toll-free telephone lines. In January 2006, the automated menus and messages were updated to reduce taxpayer confusion and provide taxpayers faster access to needed information.

The National Taxpayer Advocate's report states that the AUR toll-free line seldom succeeds in resolving taxpayers' issues and includes data that reflects only seven percent of calls result in case closure. A reasonable inference from this statement is that the AUR telephone system is inefficient or ineffective. That would be misleading. The fact is that taxpayers most often use the AUR telephone system to ask questions to gain a better understanding of how to resolve the issue that caused the CP 2000, such as what type of documents to supply. In addition, in most cases AUR tax examiners do not have authority to close a case on the phone, rather they must receive and verify the appropriate documentation in writing.

The National Taxpayer Advocate also states that the IRS is not processing correspondence in a timely fashion and cites statistics that reflect the overage rate for W&I and SB/SE as 36 percent and 20 percent respectively. These figures are misleading as they represent a snapshot in time for a given week at the end of the fiscal year. Overage varies in direct correlation to the number of notices issued and the volume of taxpayer written responses. For example, when the overall inventory is low, such as at the end of the year, the overage percentage is high. When the overall inventory is high, the overage percentage is lower. Even so, we agree that we need to improve our timeliness and we are exploring ways to better manage correspondence backlogs. For example, in FY 2008 the AUR work plan will better level notice issuance in an effort to reduce the spikes in correspondence receipts.

It is also important to note, as acknowledged by the National Taxpayer Advocate, that AUR case processing is suspended where the taxpayer has contacted the IRS through correspondence. This allows the IRS time to evaluate taxpayers' submissions prior to issuing a Statutory Notice of Deficiency or making the proposed tax assessment. The same courtesy is also extended to those who call the IRS.

### **The AUR CP 2000 Notice**

External stakeholders (taxpayers and the practitioner community) and employees of TAS were engaged in the CP 2000 redesign process. These notice redesign efforts have been recognized with three awards, including the Distinguished Award from the Society for Technical Communications. The notice contains plain language, provides taxpayers with answers to frequently asked questions and has an entirely new layout that easily guides taxpayers through this multi-page notice. The notice is designed to give the taxpayer the necessary information to maximize their credits. For example, the tax year 2006 version of the AUR notice includes a change that addresses the National Taxpayer Advocate's concerns regarding taxpayers' ability to file amended returns. The Frequently Asked Questions section of the revised notice specifically instructs taxpayers to fill out Form 1040X and attach it to their response if using itemized deductions is more advantageous than the standard deduction.



## Summary

In summary, as previously agreed by the National Taxpayer Advocate, it is appropriate for IRS to issue automated notices without prior screening by tax examiners when the screen-out rate for these types of notices has historically been less than five percent. The default and abatement rates for the AUR program are quite reasonable and relatively low when viewed from the perspective of the overall AUR program. The IRS strikes an appropriate balance in allocating resources between the telephone and correspondence and is taking steps to improve its performance in both. In cooperation with external stakeholder groups the IRS has made award-winning improvements to the CP 2000 notice to improve its clarity over the last several years. The IRS will continue to search for additional opportunities to increase the program's effectiveness and efficiency while reducing taxpayer burden and protecting taxpayer rights.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate acknowledges the critical nature of the AUR program for tax compliance and reducing the tax gap. We are also certain that more can be done to enhance this important program. When the high rate of abatements for AUR is considered (88 percent for FY 2006), \$5.1 billion dollars in assessments would be reduced to only \$612 million.

We recognize that many taxpayers resolve their AUR issues before the IRS issues a Statutory Notice of Deficiency. In fact, it is our contention in this report that even more would do so if AUR:

- Customer service representatives had the authority to resolve accounts over the phone;
- Responded adequately to taxpayer correspondence and other attempts at substantiating their tax returns;
- Improved the tax examiner screening process;
- Did not include the type of complex case work that is ill-suited for an automated process; and
- CP 2000 notices were clearer.

The IRS suggests it is unfair to gauge the quality of the AUR program by evaluating the number of default assessments compared to the total number of Statutory Notices of Deficiency issued to taxpayers. The IRS would prefer to judge the AUR program quality by comparing the number of defaulted assessments to all of the AUR notices it sends out. The IRS's position is not logical. To operate within IRC § 6211, the IRS can only impose a default tax assessment on accounts where taxpayers have been issued the notice of deficiency. Including all other AUR notice types in figuring the rate of default assessments

only serves to improve the appearance of the figures for the AUR program. It provides no clear reflection of the AUR process or its inability to accurately assess tax liability from the beginning.

Likewise, the IRS suggests it is unfair to gauge the quality of its AUR program by comparing the number of abatements to the number of requests for abatements. The purpose of evaluating the percentage of abatements is to determine whether the IRS takes all of the information available into consideration before making the assessment. The IRS would prefer to be judged through a comparison between all AUR cases and the number of abatements of tax. Again, however, the IRS calculation would destroy the usefulness of the quality measure since numerous cases are resolved (in the taxpayer's favor or the IRS's favor) before the tax is assessed. To count those cases in favor of the IRS simply distorts the measure to the point of uselessness and would not truly reflect the rate of abatements for AUR. The rate of abatement directly correlates to the number of default assessments, as abatements can only take place on cases that have been assessed tax.

We praise AUR's efforts to enhance toll-free service by implementing Universal Call Routing and updated Automated Menus and Messages, as some improvement has been realized in AUR's level of service. However, Universal Call Routing still does not allow the AUR tax examiner access to the AUR case if it was not started at the particular AUR site where the call has been routed.

The IRS reasoning in its response to AUR's failure to provide service to toll-free customers — asserting that the majority of AUR taxpayers prefer to address their issues via correspondence — is symptomatic of the very problems addressed in this report regarding the lack of service offered for AUR toll-free customers. As shown in Table , AUR Toll-free Customer Service Data, one out of four taxpayers do not have their calls answered, which is unacceptable and inexcusable.

While there is no excuse for failing to provide a service to those taxpayers who do attempt to call AUR toll-free lines, the IRS's response would suggest that it maintains a high quality response to taxpayer correspondence. The data shows that this is not happening. Not providing timely correspondence or toll-free service increases the volume of each type of contact, as taxpayers try both methods to resolve their AUR issues. The IRS should conduct further analysis to determine if taxpayers use written correspondence to resolve their AUR issue because they prefer that mode of contact. As was shown in TAS's review of AUR TAMIS cases, 220 out of 386 (57 percent) of the taxpayers indicated they had previously called or written AUR without resolution, leading to their need to contact TAS for assistance. Further, review of AUR toll-free calls showed 21 percent of taxpayers were calling because they received no response to their initial AUR contact. The review data raises the following questions: Are taxpayers responding in writing because they cannot get through on the toll-free lines,? Or is the problem that once they get through on the toll-free lines, their case is not resolved and they are advised to write to the IRS? There is

clearly a need for AUR to timely process correspondence, returns, and toll-free calls. Failure to provide any of these services increases both correspondence and toll-free contact to the AUR program. The lack of service provided by AUR is of particular concern to the National Taxpayer Advocate in light of the foreclosure crisis.<sup>40</sup>

We do not cite to data reflecting that only seven percent of AUR toll-free calls result in case closure to assert that the AUR is inefficient or ineffective. We believe toll-free service for AUR is a valuable tool that should be enhanced to provide better quality service to taxpayers. Allowing AUR tax examiners the authority to close cases while on a call when the taxpayer provides adequate oral statements to resolve their AUR issue would serve to:

- Improve customer satisfaction;
- Reduce correspondence;
- Improve timeliness; and
- Improve AUR toll-free level of service.

We clearly state that only some notices are completely automated. However, it is also clear from taxpayer and preparer complaints that AUR tax examiners often overlook income information that warrants the closure of a case. This oversight then unnecessarily results in the issuance of AUR notices and forces taxpayers to respond to inquiries. The IRS can do more to enhance systemic identification of AUR cases and thus reduce tax examiner errors.

The National Taxpayer Advocate is pleased that the IRS continues to revise the award-winning CP 2000 to enhance its clarity. As is noted in the report, both taxpayer complaints and customer satisfaction surveys indicate the CP 2000 still lacks clear direction and is confusing for many taxpayers.

## Recommendations

The National Taxpayer Advocate recommends the IRS take the following steps to provide assistance with, enhance access to, and promote effective tax compliance within the AUR program:

- Revise current AUR programming to ensure taxpayers are not needlessly affected by AUR. Take the actions suggested by the 2007 Government Accountability Office (GAO) audit, to begin obtaining all return line items when returns are transcribed to enhance compliance.<sup>41</sup> This is especially detrimental in the AUR process, where hav-

<sup>40</sup> These problems for AUR will be exacerbated for FY 08 in AUR due to the subprime mortgage crisis. See Most Serious Problem, *Tax Consequences of Cancellation of Debt Income*, *supra*.

<sup>41</sup> Government Accountability Office, GAO 08-38, *2007 Filing Season Continues Trend of Improvement But Opportunities to Reduce Costs and Increase Tax Compliance Should Be Evaluated* (Nov 15, 2007)

ing all the return information available would ensure AUR only includes taxpayers who have truly underreported income.

- Enhance systemic processing to eliminate the need for tax examiner screening. Implement quality review and measures for the current AUR manual screening process in order to establish historical data for program improvement possibilities.
- Include Failure to Pay (FTP) computations in the AUR notices issued so taxpayers will not receive an additional balance due notice after they have paid the AUR tax assessment.
- Ensure that when a taxpayer agrees to the AUR assessment and provides the required tax payment, that the payment will not refund to the taxpayer prior to the AUR assessment on the account, necessitating additional contact with AUR.
- Provide AUR assistors with the skills to establish Installment Agreements (IA) when AUR taxpayers call and request agreements to resolve their tax debts, or have a message directing the taxpayer to the appropriate toll-free line to handle an IA.
- Provide AUR toll-free assistors with the training to allow computation of the total balance due (tax + penalty + interest) as a result of the AUR assessments or program this information into AUR notices.
- Determine if the taxpayer has experienced a tax benefit as a result of state refunds through the systemic process to exclude AMT filers and state refund issues when they have not.
- Include a total income test when AUR evaluates reported income. If the total income reported on the return as a whole matches that reported by third party IRP documents, the IRS should not pursue the case. This policy would ensure that the AUR program does not needlessly pick up taxpayers who simply report income on incorrect lines on their returns.
- Provide IRS data systems with the same information that payer forms provide to taxpayers so the IRS can avoid taking unnecessary action on taxpayers' accounts. This can be accomplished by changing programming to pick up cost basis when provided by payers, many of whom already provide the required information.<sup>42</sup>
- Take the necessary steps to provide and improve toll-free service for AUR. AUR should also consider enhancing and expanding policy and procedures to include oral statement resolution, making better use of the resources expended for toll-free service.
- Establish universal account access for the AUR system, thus providing any AUR toll-free assistor with the ability to access and take appropriate case actions on taxpayer

<sup>42</sup> Government Accountability Office, GAO-06-603, *Capital Gains Tax Gap, Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed* 22 (June 2006).

accounts. Implementation of universal access would improve customer service, reduce resource expenditure, and improve timeliness for AUR.

- Improve correspondence, notice, and return processing to meet the established IRM 30-day requirement to prevent default assessments and subsequent reconsideration in the AUR program.<sup>43</sup>
- Consider establishing a consolidated AUR site for correspondence and return handling to improve timeliness and accuracy.
- Provide more clear instructions to clearly include prior year state or local tax refunds to Line 7 of the 1040A and Line 1 of the 1040EZ instructions to reduce the chance of involuntary noncompliance.
- Provide clear instruction in the CP 2000 notice such as that in the soft notice to include, but not be limited to:
  - ◇ Do not file an amended return for the year in question. Call or write if you dispute only the income attributed to you in this notice.
  - ◇ Do file an amended return if you have deductions or expenses that offset the proposed income item attributed to you if you agree that such income is properly attributed to you. Do not file an amended return if you dispute the income attributed to you in this notice.
  - ◇ If the income attributed to you stems from an error on your part and that error has occurred in other years, file an amended return for those tax years for which the same error occurred.

<sup>43</sup> See National Taxpayer Advocate 2006 Annual Report to Congress 248.

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## The Accuracy-Related Penalty in the Automated Underreporter Units

### Responsible Officials

Richard J. Morgante, Commissioner, Wage and Investment Division

Kathy K. Petronchak, Commissioner Small Business/Self-Employed Division

### Definition of Problem

The lack of human intervention in the IRS's Automated Underreporter (AUR) program too often leads the IRS to erroneously propose and assess the accuracy-related penalties<sup>1</sup> of Internal Revenue Code (IRC) § 6662.<sup>2</sup> A system that too frequently assesses and then abates (or proposes to assess and then removes) penalties harms taxpayers and IRS tax administration. Taxpayers must spend time searching for records, calling and corresponding with information return providers and the IRS, and often paying tax professionals to seek abatement of uncalled-for penalties. IRS personnel must spend time fielding calls, reviewing correspondence, creating reports, and obtaining approval to eliminate unnecessary penalties.

IRC § 6751 requires IRS managerial approval for assessments of penalties unless they are computed electronically.<sup>3</sup> The IRS interprets this language to support the automatic imposition of the negligence portion of the accuracy-related penalty in the AUR. The National Taxpayer Advocate believes this policy may be inconsistent with the law on negligence and that the policy contributes to erroneous assessments of the accuracy-related penalty.

### Analysis of Problem

#### Background

The IRS Examination functions, including the AUR, strive to develop compliance strategies with the aim of improving voluntary compliance and customer service.<sup>4</sup> IRS policy states that penalties exist to encourage voluntary compliance by supporting the standards of behavior expected by the Code.<sup>5</sup> Penalties encourage voluntary compliance by:

<sup>1</sup> This report focuses exclusively on two accuracy-related penalties: the negligence penalty under IRC § 6662(b)(1), and the substantial understatement penalty under IRC § 6662(b)(2). IRC § 6662 and other Code sections contain additional accuracy-related penalty provisions. However, to our knowledge, the IRS has programmed its AUR computer system to impose only these two penalties.

<sup>2</sup> See Most Serious Problem, *Automated Underreporter*, *supra*. The AUR is an automated program that generates casework by systemically comparing tax information shown on IRS information returns to tax information reported by taxpayers.

<sup>3</sup> IRC § 6751(b)(2).

<sup>4</sup> Internal Revenue Manual (IRM) 20.1.1.2(1) (Aug. 20, 1998).

<sup>5</sup> IRM 20.1.1.2 (1) (Aug. 20, 1998).

- Defining standards of compliant behavior;
- Defining remedial consequences for noncompliance; and
- Providing monetary sanctions against taxpayers who do not meet the standards.<sup>6</sup>

### The Accuracy-Related Penalty Under IRC § 6662

IRC § 6662 imposes the accuracy-related penalty on the portion of an underpayment of tax attributable to negligence or substantial understatement. Taxpayers may be subject to a 20 percent accuracy-related penalty applied to:

1. An income tax underpayment that is attributable to the taxpayer's negligence or disregard of rules or regulations;<sup>7</sup> or
2. The taxpayer's substantial understatement of the correct amount of tax.<sup>8</sup>

The negligence penalty applies when a taxpayer fails to make a reasonable attempt to comply with tax laws.<sup>9</sup> The substantial understatement penalty is a computational measure that applies when the amount of tax that the taxpayer reports differs by the greater of \$5,000 or ten percent from the correct amount of tax that the taxpayer should have reported.<sup>10</sup> The IRS may not "stack" the negligence and substantial understatement accuracy related penalties to exceed the 20 percent rate.<sup>11</sup> In other words, if the IRS establishes that a taxpayer both was negligent and substantially understated the tax, the maximum accuracy-related penalty would still cap at 20 percent of the related amount of the understated tax.<sup>12</sup>

A taxpayer may avoid or have the IRS abate both penalties by establishing a reasonable basis for his or her position.<sup>13</sup> The taxpayer may have relied on a legitimate authority, such as Treasury regulations, congressional committee reports, or court cases.<sup>14</sup> Alternatively, a taxpayer may have acted with reasonable cause and good faith.<sup>15</sup> Facts and circumstances on a case-by-case basis determine how a taxpayer acted.<sup>16</sup>

### Managerial Involvement and IRC § 6751(b)

Except in limited circumstances, IRC § 6751 prohibits the IRS from assessing any penalty unless an IRS supervisor personally pre-approves the penalty in writing. Congress' purpose

<sup>6</sup> IRM 20.1.1.2 (1) (Aug. 20, 1998).

<sup>7</sup> IRC § 6662(b)(1).

<sup>8</sup> IRC § 6662(b)(2).

<sup>9</sup> IRC § 6662(c). For a full explanation of this provision and analysis of cases on this topic, see Most Litigated Issue, *Accuracy-Related Penalty Under Internal Revenue Code Sections 6662(b)(1) and (2)*, *infra*.

<sup>10</sup> IRC §§ 6662(d)(1)(A)(i) and (ii).

<sup>11</sup> Treas. Reg. § 1.6662-2(c).

<sup>12</sup> *Id.*

<sup>13</sup> Treas. Reg. § 1.6662-3(b)(3).

<sup>14</sup> Treas. Reg. § 1.6662-4(d)(3)(iii).

<sup>15</sup> IRC § 6664(c)(1); see *also* Treas. Reg. § 1.6662-3(b)(3).

<sup>16</sup> Treas. Reg. § 1.6664-4(b)(1).



in requiring supervisory approval is to ensure that an individual IRS examiner or collection officer does not use the penalty as a “bargaining chip” to coerce the taxpayer’s acquiescence in the underlying substantive tax matter.<sup>17</sup> Congress, however, waived the supervisory approval requirement for four mechanically based penalties<sup>18</sup> and for cases where the IRS “automatically calculated the penalty through electronic means.”<sup>19</sup> The IRS interprets this latter exception as allowing its computers to automatically compute the negligence penalty without the exercise of human judgment.<sup>20</sup>

### Assessment of Penalties in the AUR Program

Under Examination’s AUR program, IRS computers systemically compare tax information from third party information returns (*e.g.*, on a Form 1099) to entries that taxpayers report on their tax returns. While the program is automated, the IRS requires tax examiners to review each proposed adjustment. However, the IRS does not require the examiners or other employees to review AUR’s proposed assessments of penalties. The AUR systems impose the negligence penalty on all taxpayers that meet certain criteria, specifically on those that have a history of noncompliance and have a similar error in the current year (*e.g.*, failure to report income from an information return). Thus, the IRS bases its automated determination of negligence on one mechanical aspect of the taxpayer’s compliance rather than on the entire facts and circumstance of the case. Critically, nowhere does the IRS’s automated system consider the taxpayer’s intent.

In a March 24, 1988, report entitled “Description of Tax Penalties,” the Joint Committee on Taxation stated that Congress first enacted the negligence (and fraud) penalties as part of the Revenue Act of 1918, Public Law No. 254, February 24, 1919.<sup>21</sup> The Committee stated:

One important aspect of both of these penalties that has existed from the date of their original enactment is fault: the intent of the taxpayer is vital to determining whether the penalty applies in a particular circumstance. Indeed, an element of fault seems inherent to concepts of negligence or fraud.

The Joint Committee issued its report one year before the Omnibus Budget Reconciliation Act of 1989, which amended the IRC § 6662 accuracy-related negligence penalty and other statutory penalties.<sup>22</sup> The House of Representatives Budget Committee Report dated

<sup>17</sup> S. Rep. 105-174 at 65 (1998).

<sup>18</sup> IRC § 6751(b)(2)(A) waives the supervisory approval requirement for penalties under IRC § 6651 (Failure to File and Failure to Pay); IRC § 6654 (Failure by an Individual to Pay Estimated Income Tax); and IRC § 6655 (Failure by a Corporation to Pay Estimated Income Tax).

<sup>19</sup> IRC § 6751(b)(2)(B).

<sup>20</sup> Memorandum from Martha Sullivan, Deputy Director, Compliance Policy, *Revision to Memorandum (Aug. 14, 2000) Restructuring and Reform Act of 1998 (RRA98) Section 3306 – Managerial Approval and Notice Requirements of Penalties* (Apr. 24, 2001), concluding:

Section 6751(b) provides an exception for managerial approval of penalties calculated through electronic means. This means that the penalty must be free of any independent determination by a Service employee as to whether or not the penalty should be imposed against a taxpayer.

<sup>21</sup> Joint Committee on Taxation, *Description of Tax Penalties* (JCS-9-88) (Mar. 24, 1988) at 17.

<sup>22</sup> H.R. Rep. No. 101-247 at 1387-1389 (1989).

September 20, 1989, stated that Congress *removed* the following sentence from the then existing negligence penalty:

An underpayment of tax that is attributable to a failure to include on an income tax return an amount shown on an information return is treated as subject to the negligence penalty absent clear and convincing evidence to the contrary.

The National Taxpayer Advocate is concerned that the IRS's approach to the automatic assessment of the negligence penalty based solely on one factor, the taxpayer's compliance history, runs counter to Congress' express rationale for providing this exception. A proper determination of negligence requires judgment and discretion applied to a complete set of facts and circumstances. The IRS's current approach assumes the taxpayers were negligent without first making the appropriate inquiry into the facts, including the taxpayer's intent. In light of the high level of penalty abatements in AUR, it appears this approach leads to inaccurate proposed penalties and assessments, and imposes burden on taxpayers.

#### AUR Penalty Abatement Rate Exceeds that of Other Programs

As noted above, penalties are designed to encourage voluntary compliance. This goal is not served when IRS functions erroneously propose or assess penalties. Table 1.18.1 below demonstrates the high rate of penalty abatements in the Small Business/Self-Employed (SB/SE) division's AUR unit compared to the other SB/SE examination functions.<sup>23</sup>

**TABLE 1.18.1, Comparison Among SB/SE Exam Functions of Assessments and Abatements of the IRC § 6662 Penalty**

Fiscal Year	Division	Function	Assessments of Penalty	Abatements of Penalty	Percentage of Penalty Abatements
2004	SB/SE	AUR	62,787	10,481	17%
2005	SB/SE	AUR	75,146	7,479	10%
2004	SB/SE	Campus Exam	5,908	436	7%
2005	SB/SE	Campus Exam	4,335	198	5%
2004	SB/SE	Field Exam	20,948	644	3%
2005	SB/SE	Field Exam	31,596	379	1%

As Table 1.18.1 shows, the IRS abated a combined 13 percent of the assessments for the AUR program for fiscal year (FY) 2004 and FY 2005, but abated approximately three percent in the non-automated programs for the same period. This data is consistent with the data in Table 1.18.2 below comparing proposed versus actual assessments of the penalty in the SB/SE and Wage and Investment (W&I) AUR units from FY 2004 through FY 2006.

<sup>23</sup> TAS requested comparable data from the Wage and Investment (W&I) division; however, W&I does not maintain this information.

**TABLE 1.18.2,<sup>24</sup> Combined W&I and SB/SE Comparison of the Percentage of AUR Proposed to Assessed Accuracy-Related Penalties**

Fiscal Year	AUR Proposed Assessments of Accuracy-Related Penalty	AUR Actual Assessments of Accuracy-Related Penalty	Percentage of AUR Assessed to Proposed Accuracy-Related Penalties
2004	358,277	133,842	37%
2005	456,907	169,729	37%
2006	627,089	202,782	32%

On average, the IRS actually assesses only 35 percent of the proposed accuracy related penalties.<sup>25</sup> This statistic suggests that while the AUR program is subjecting more taxpayers to the possibility of a penalty, it is increasingly failing to accurately identify those who *should be* subject to the penalty. The IRS sends a notice to each affected taxpayer explaining that a discrepancy exists between the information provided by the taxpayer and that provided by an information return. In all situations where AUR proposes a penalty, if the taxpayer fails to respond, the AUR program assesses the penalty without any human review. If the taxpayer does reply, an employee reviews the response before assessing the penalty, which if warranted cannot be assessed without a manager's review and concurrence.<sup>26</sup>

While the accuracy-related penalties proposed by the AUR program increase each year, the actual assessments on taxpayers have not increased significantly. Table 1.18.2 demonstrates that despite the overall increase in assessments, the percentage of proposed penalties that the IRS actually assessed has fallen from 37 percent to 32 percent during that time. This decline suggests that while the IRS is proposing the accuracy-related penalty on an increasing number of taxpayers, those taxpayers are showing the IRS that the penalty should not apply.

### *Problems with IRS Tracking of Results*

The IRS uses the accuracy-related penalty as a tool to improve compliance, yet it tracks very little information about the imposition and abatement of the penalties. The AUR retains information about the number of penalties proposed and assessed but does not track the number of penalties waived. The Field and Campus Exam functions of the W&I and SB/SE divisions track the number of penalties assessed. W&I, however, could provide only limited data on abatements from certain Campus Exam sites. Likewise, SB/SE was able to provide data only from the Enforcement Revenue Information System.<sup>27</sup> Moreover, W&I

<sup>24</sup> IRS, *Response to TAS Project Request Accuracy-Related Penalties SB/SE and W&I Data* (Aug. 9, 2007). For FY 2004, W&I proposed 164,122 accuracy related penalties and assessed 78,348. For FY 2005, the numbers increased to 241,335 penalties proposed and 104,593 assessed and for FY 2006, to 371,159 proposed and 131,966 assessed. For FY 2004, SB/SE proposed 194,155 accuracy-related penalties and assessed 55,494. For FY 2005, the numbers increased to 215,572 penalties proposed and 65,136 assessed and for FY 2006, to 255,930 proposed and 70,816 assessed.

<sup>25</sup> This calculation of the percentage is a raw number based on the data in table. We were unable to determine the number of accuracy-related penalties removed due to reasonable cause because the operating divisions do not track that data.

<sup>26</sup> For more information on the AUR program, see Most Serious Problem, *Automated Underreporter*, *supra*.

<sup>27</sup> The Enforcement Revenue Information System gathers data from across the IRS, collecting information about enforcement revenue and the associated costs. It processes more than nine billion transactions, both current and historical, and generates more than 139 million summary records annually.

and SB/SE do not track the number of *proposed* accuracy-related penalties in their Field Exam and Campus Exam functions. The first step towards determining whether a compliance policy is working is to retain and analyze relevant data. Until the IRS fully tracks this process, it is unclear how the operating divisions can determine how or where to allocate additional resources or implement changes.

## Conclusion

The IRS should not hold the view that because the AUR is an automated program, that it is nearly error free. Elsewhere in this report, we have detailed our concerns about the AUR program's systems, its high reversal rate, and the burden it places on taxpayers. The absence of human review in the AUR penalty proposal regime too often leads the IRS to the wrong conclusion about whether taxpayers were negligent. This methodology causes extra work for everyone involved: for taxpayers, tax professionals, and the IRS, which must correct the errors that AUR creates. A simple remedy is available. The National Taxpayer Advocate recommends that the IRS add a human level of review whenever the AUR systems propose the negligence portion of the accuracy related penalty.

## IRS Comments

### Background

Underreporting of income by individual taxpayers is a serious concern and a major contributor to the nation's tax gap. The AUR program, one of the most effective and efficient compliance programs in the IRS, is a critical component in addressing this component of the tax gap.

The AUR program is a highly computerized document matching program that compares a taxpayer's return with third party information returns. If the AUR program finds a discrepancy between the taxpayer's return and the third party information return, the program calculates a deficiency and generates a CP2000 letter to the taxpayer requesting an explanation. The negligence portion of the accuracy related penalty is systemically proposed only when a taxpayer has a history of underreporting the same income and fails to respond to the CP2000 or statutory notice. In those instances, the penalty is used to encourage voluntary compliance and to encourage the taxpayer to address any discrepancies between his or her filed return and the information reported by third parties. In every case where a taxpayer follows the instructions in the CP2000 and replies, the taxpayer's explanation is considered by an AUR tax examiner assigned to work the case.

Where the taxpayer fails to respond to the AUR notice, the system is appropriately imposing computer generated accuracy-related penalties without the need for managerial approval. Not only is this in accordance with the law, such review would serve no purpose because without a taxpayer response the manager or other employee would have nothing more to consider.

### Written Supervisory Review Requirements of IRC § 6751

Notwithstanding the National Taxpayer Advocate's suggestion to the contrary, if taxpayers fail to respond and accuracy-related penalties are systemically assessed, the penalties qualify under IRC § 6751(b)(2)(B) as penalties automatically calculated through electronic means. As a result, the penalties are specifically excepted from the general rule that requires written managerial approval.

When the taxpayer responds to an AUR notice, a tax examiner will manually review the response. The tax examiner has the authority to waive penalties if the taxpayer provides evidence to establish they do not apply. If the tax examiner believes accuracy-related penalties should still be asserted, written managerial approval is required in accordance with the general rule of IRC § 6751(b)(1).

### Systemic Assessment of the Negligence Penalty

The IRS does not agree with the National Taxpayer Advocate's position that the IRS needs to add a human level of review whenever the AUR program proposes the negligence portion of the accuracy-related penalty. Treasury Regulation § 1.6662-3(b)(1)(i) expressly states that negligence is strongly indicated where a taxpayer fails to include on an income tax return an amount of income shown in the information return. Even so, the AUR program only proposes the accuracy-related negligence penalty when a taxpayer has a history of not reporting the same type of income in a prior year. This provides an even stronger indication of negligence. In these repeater instances, the penalty is proposed to encourage voluntary compliance and to prompt the taxpayer to address and correct discrepancies between his or her tax return and the information reported by third parties.

Prior to actual assessment, a taxpayer is afforded an opportunity to furnish information to address the underlying discrepant income and any proposed accuracy-related negligence penalty. The computer generated CP2000 notice includes instructions that advise taxpayers that if they disagree with the proposed penalty, they should respond to the notice and provide an explanation with any supporting documentation they want the IRS to consider.

As importantly, it is essential to understand that the AUR program is not an audit program where a taxpayer's books and records are examined to substantiate income, deductions, and credits. Taxpayers are given nearly six months to respond to an AUR notice before default assessment of tax and penalties. In the case of the accuracy-related negligence penalty, taxpayers should be familiar with the notice and the need to respond because the penalty is only proposed when the taxpayer has a history of noncompliance on the same issue in a prior year. Absent a response from the taxpayer, an AUR tax examiner would have no more information at his or her disposal in making a penalty determination than the computerized AUR program itself. As a result, the proposed human level intervention would only further delay the assessment.

### Efforts to Address Taxpayer Burden

Key goals of the AUR program are to minimize taxpayer burden and to increase IRS efficiency. To help accomplish these goals, as noted in the IRS response to the National Taxpayer Advocate's Most Serious Problem, Automated Underreporter, 95 percent of all AUR notices are subject to employee screening prior to issuance. During this process, tax examiners thoroughly review the entire return for misplaced entries or other discrepancies that the IRS can resolve without taxpayer contact. This manual screening is done to prevent the issuance of AUR notices in error. Only five percent of AUR notices are completely automated and are limited to situations where the screen out rate for the kinds of underreported items involved has historically been five percent or less.

### Abatement Rate Comparisons

In the AUR program, a relatively small percentage of all AUR notices involve accuracy-related penalties. For example, for fiscal years 2004 – 2006, the AUR program proposed the accuracy-related penalty due to negligence on less than 2.2 percent of all notices issued.

With respect to the abatement rates for these accuracy-related penalties, the National Taxpayer Advocate's report includes statistics that compare assessments and abatements between the AUR program and the campus and field examination functions in SB/SE. As noted above, the AUR program is based exclusively on the matching of income reported on the tax return with information provided to the IRS by third parties. In contrast, campus and field audits are based on examinations of unreported income, overclaimed expenses, dependency issues, deduction qualification issues, credit eligibility, and many other audit issues. Because the AUR program and the campus and field examination programs do not involve similar cases or IRS employee interactions with taxpayers, comparisons of proposed and abated penalties between these programs are not particularly probative.

Further, the way these data are arrayed in the context of the National Taxpayer Advocate's discussion of a taxpayer's ability to have IRS abate penalties by establishing they acted with reasonable cause or had a reasonable basis for their position, it implies that the cited abatement rates are strictly due to penalty-related taxpayer responses. However, the penalty abatement data used by the National Taxpayer Advocate include cases where the taxpayer provided information, irrespective of the proposed penalty, to establish that they were not subject to tax on the unreported income or that reduced the amount of the unreported income involved below the threshold for application of accuracy-related penalties. In such cases, the penalties no longer apply and they are automatically waived by IRS.

Finally, the National Taxpayer Advocate's report includes data that shows the IRS assessed only 35 percent of proposed accuracy-related penalties for substantial understatement and negligence during fiscal years 2004 – 2006. The National Taxpayer Advocate states these statistics suggest that while the AUR program is subjecting more taxpayers to the possibility of a penalty, it is increasingly failing to accurately identify those who should be subject

to the penalty. However, when these same data are arrayed a bit differently, they reveal that on average fully 80 percent of the accuracy-related penalties due to negligence are in fact assessed. In addition, abatements of accuracy-related penalties due to substantial understatement are often automatically abated because the taxpayer replied to the CP2000 notice and provided evidence that they did not receive the unreported income involved.

### Problems with IRS Tracking of Results

The IRS recognizes the AUR program's current inability to fully quantify all instances where the accuracy related penalty is waived. The IRS has requested programming to change the AUR monitoring system to address this issue. A work request that will permit the tracking of all cases on which accuracy-related penalties have been waived was submitted for consideration for FY 2009. However, as previously noted, the campus and field examination programs are not comparable to AUR. As a result, we have no plans to revise current management information systems to track proposed accuracy-related penalties in the campus or field examination functions.

### Summary

Accuracy-related penalties are involved in a small percentage of AUR cases. Taxpayers are afforded almost six months to respond to the AUR notices. When they fail to do so, fully consistent with provisions of the Code, the AUR program systemically processes accuracy-related penalties without managerial approval and appropriately assesses the accuracy-related negligence penalty upon the expiration of the statutory notice of the default period.

The IRS strives to reduce taxpayer burden and to increase the efficiency of the AUR program by pre-screening over 95 percent of all notices to ensure they are not issued in error. The IRS does not agree that AUR penalty abatement rates are comparable to those of the campus and field examination programs. Nor do we agree there is sufficient data to support a conclusion that the AUR program routinely proposes inappropriate accuracy-related penalties.



## Taxpayer Advocate Service Comments

We agree that valid business reasons exist for utilizing the AUR program to address non-compliance and the tax gap. However, we strongly believe the IRS can improve the program, as discussed elsewhere in this report.<sup>28</sup> This Most Serious Problem addresses the IRS's practice of proposing and assessing the negligence portion of the accuracy-related penalty in the AUR, and utilizing a computer to make decisions without any human involvement.

The IRS response above contains numerous contradictions and unsupported assumptions that go to the heart of our concerns about this program. For example, the IRS applauds itself for having its employees screen 95 percent of AUR notices questioning taxpayers' assertion of their taxable income. Obviously, the IRS appreciates the necessity of human involvement in the areas where discretion is exercised. Yet, when the IRS determines taxpayer negligence, it utilizes no human involvement (*i.e.*, zero percent) to weigh the subjective factors necessary to determine whether negligence was present. For important reasons, human involvement by IRS employees is necessary *before* imposing the negligence penalty. We summarize below some of these reasons and recommend improvements to the program.

### *Managerial Review Under IRC § 6751*

The IRS argues that it is following an acceptable interpretation of IRC § 6751(b)(2)(B) which requires managerial involvement before the assessment of most penalties but creates an exception for penalties calculated through electronic means. It is difficult for us to arrive at the conclusion that Congress wanted managerial involvement for some penalty determinations but did not want managers looking at the most subjective determination of all (*i.e.*, the negligence portion of the accuracy-related penalty based on an assessment of the taxpayer's intent). The IRS has provided no legal analysis for its statement. What it appears to be saying is that it, the IRS, has determined that if a taxpayer has within the last three years failed to report information from the same type of 1099 form, the IRS will impute negligence. This is a *per se* liability rule, which Congress expressly eliminated by amending the statute in 1989.

The following two scenarios illustrate some of the problems with the IRS's *per se* negligence presumption. For the first scenario, suppose the taxpayer accurately reported Form 1099 amounts in year one; however, due to AUR system limitations, the IRS issued AUR matching letters in August and September, proposing adjustments to the taxpayer's return. If the taxpayer had moved by then, or did not receive the IRS notices for any reason, the IRS would assess a tax for year one because the taxpayer was unable to respond timely to the IRS's notices. Suppose further that in year two the taxpayer files a return treating

<sup>28</sup> See *Most Serious Problem: Automated Underreporter*, *supra*.

the Form 1099 amounts in the same manner as he or she had been done in year one. As a result, the IRS's AUR system will automatically determine that the taxpayer is *per se* negligent for year two. The IRS would never have investigated the taxpayer's intent, and the taxpayer would not even know that he or she was considered a negligent repeat offender.

For the second scenario, suppose a taxpayer did not receive a Form 1099 three years ago (year one). Suppose further that in year four the taxpayer failed to report similar Form 1099 income but correctly reported all Forms 1099 income in years two and three. The IRS's AUR would automatically consider year four as *per se* negligent regardless of the reasons for the taxpayer's actions.

### ***Same Information Return Type as Prior Year Is not Sufficient to Presume Negligence***

The IRS response asserts that the negligence penalty is "systemically proposed only when a taxpayer has a history of underreporting the same income and fails to respond to the CP2000 notice or statutory notice." This statement is misleading as it suggests that in these cases the IRS has determined the taxpayer has not reported the very same income in the current year as had been unreported and assessed in a prior year. In fact, the penalty is proposed if the information return at issue in the current year (*i.e.*, Forms 1099-Misc, 1099-R, 1099-D, etc.) is the same information return at issue from a prior year. Here, the IRS makes a faulty assumption that an issue with respect to the current year's Form 1099 is the same issue that existed in a prior year. Our analysis of the AUR program elsewhere in the report gives the example of a taxpayer who received a Form 1099-B from her broker, with information about a short sale of stock that was not taxable. Had a human analyzed this form, the IRS would have presumably been able to determine the transaction was not taxable. The example also demonstrates the variety of information that can appear on a Form 1099 from year to year. One Form 1099-B may contain information about a non-taxable short sale, whereas another form may contain information about a taxable stock sale. The IRS cannot make assumptions about negligence simply because it has raised issues on a taxpayer's Forms 1099 in multiple years.

To support its belief that human review will not improve this process, the IRS cites Treasury Regulation § 1.6662-3(b)(1)(i), which states that negligence is strongly indicated where a taxpayer fails to include on an income tax return an amount of income shown in an information return. However, Treasury Regulation § 1.6662-3(b)(1) provides that "negligence" includes any failure to make a reasonable attempt to comply with provisions of the internal revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return. The word "reasonable" suggests at least some level of human involvement is needed to determine what is reasonable. It does not suggest a *per se* liability rule such as the IRS is applying. Given the clear legislative history, the Joint Committee of Taxation report, and Congress' 1989 change to the statute, the IRS practice does not appear to comply with IRC § 6751.

### *Abatement Rate Comparisons*

The IRS believes it is not proper to compare the abatement rates for AUR with those for Field Compliance and the campuses due to the differences in those programs. The fact that the AUR is a matching program with less complex issues than those in the Examination functions, coupled with the fact that the IRS reviews 95 percent of the issues before the notices are sent, suggests to us that the abatement rates in the AUR program should be lower than in Field Compliance and the campuses. The fact that the abatement rate of the AUR accuracy-related penalty is significantly higher than that of the IRS Examination functions supports our assertion that the IRS should not automatically make negligence determinations.

### *IRS Tracking of Results*

The IRS has acknowledged the current AUR program has limitations and has taken steps to improve the tracking of all cases. The National Taxpayer Advocate is pleased by these steps and looks forward to seeing how these changes will improve the overall process. However, the IRS has not indicated what, if any interim steps it plans to take while waiting for the FY 2009 work request to be accepted and implemented.

## Recommendations

The National Taxpayer Advocate recommends that the IRS take the following actions:

- IRS employees should make individual determinations when proposing and assessing the negligence portion of the accuracy-related penalty in the AUR program; and
- The IRS should retain data pertaining to the AUR negligence penalties that it proposes and does not assess, and the reasons for the non-assessment.

MSP  
#19**Audit Reconsiderations****Responsible Officials**

Richard J. Morgante, Commissioner, Wage and Investment Division

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division

**Definition of Problem**

An audit reconsideration is the evaluation of a prior audit where additional tax was assessed and remains unpaid, or a situation when a taxpayer contests a “substitute for return” determination by filing a delinquent return.<sup>1</sup> Audit reconsiderations are rework, and are costly to both the taxpayer and the IRS. In fiscal year (FY) 2006, the IRS closed audit reconsiderations of tax assessments exceeding \$1.7 billion by abating over \$1.2 billion (69 percent) of those original audit assessments.<sup>2</sup>

The IRS must balance its strategic goals of reducing audit cycle time and improving detection of noncompliance<sup>3</sup> with taxpayers’ need for effective communication and accurate resolution of tax controversies. When the IRS does not convey its goals to employees in a balanced fashion, it risks creating rework such as audit reconsiderations. Current audit practices that undermine the IRS’s strategic goals and risk harming taxpayers include:

- IRS internal guidance that encourages early case closure but does not encourage solving the taxpayer’s problem;
- Use of the combination letter, which shortens response time and may lead to incomplete examinations;
- Lack of telephone contact to resolve issues, which may increase the likelihood of rework; and
- Lack of address searches beyond internal IRS data, which lessens the chance of establishing contact with the taxpayer.

<sup>1</sup> IRC § 6020(b) grants the IRS authority to prepare a return, *i.e.*, a substitute for return, if a taxpayer fails to file as required.

<sup>2</sup> IRS, *Enforcement Revenue Information System (ERIS) SDB 721 Database* (Apr. 2007). The original tax assessments totaled \$1,743,536,408. The total tax abated through the audit reconsideration process was \$1,204,980,389.

<sup>3</sup> IRS, *IRS Strategic Plan 2005-2009* 19.

## Analysis of Problem

### Background

The IRS has the discretionary authority to abate any tax assessment that exceeds the taxpayer's liability.<sup>4</sup> An audit reconsideration is the evaluation of a prior audit where additional tax was assessed and remains unpaid, or when a taxpayer contests a "substitute for return" determination by filing a delinquent return.<sup>5</sup> Audit reconsiderations generally stem from five assessment sources;

1. Area Office (Office or Field Examination);
2. Office of Appeals;
3. Automated Substitute For Return (ASFR);<sup>6</sup>
4. Correspondence Examination; and
5. Automated Underreporter Unit (AUR).<sup>7</sup>

There are numerous reasons why an audit reconsideration becomes necessary, including:<sup>8</sup>

- The taxpayer did not receive correspondence from the IRS;<sup>9</sup>
- The taxpayer did not appear for an audit;<sup>10</sup>
- The taxpayer did not understand notices;<sup>11</sup>
- The IRS did not consider documents the taxpayer submitted;<sup>12</sup>
- The taxpayer has new evidence to present;<sup>13</sup> or
- The taxpayer lost necessary documents.

<sup>4</sup> IRC § 6404(a).

<sup>5</sup> IRC § 6020(b) grants the IRS authority to prepare a return, *i.e.*, a substitute for return, if a taxpayer fails to file as required.

<sup>6</sup> The IRS created the Automated Substitute for Return (ASFR) program to secure returns from taxpayers who fail to file. During ASFR processing, the IRS issues two letters to the taxpayer, a 30-day letter and a 90-day letter. These letters request that the taxpayer file a return or explain why the taxpayer is not required to file. If a return is not received by the end of the 90-day period, a default assessment is created. Tax, penalties, and interest are assessed to the taxpayer's account based on the net tax due from information documents filed with the IRS. If an original return is received after the ASFR default assessment has posted and the assessment remains unpaid, the case is classified as an ASFR Reconsideration case. In most instances, an adjustment to the taxpayer's account is needed.

<sup>7</sup> The Automated Underreporter Unit performs automated analysis and processing of potential under-reported and/or over-reported issues identified through information return matching. See Most Serious Problem, *Automated Underreporter*, *supra*.

<sup>8</sup> The National Taxpayer Advocate supported a study of EITC audit reconsiderations and reported the findings in her 2004 Annual Report to Congress. The research shed light on the reasons why taxpayers seek audit reconsideration. National Taxpayer Advocate 2004 Annual Report to Congress vol. 2.

<sup>9</sup> IRM 4.13.1.3 (Oct. 1, 2006).

<sup>10</sup> *Id.*

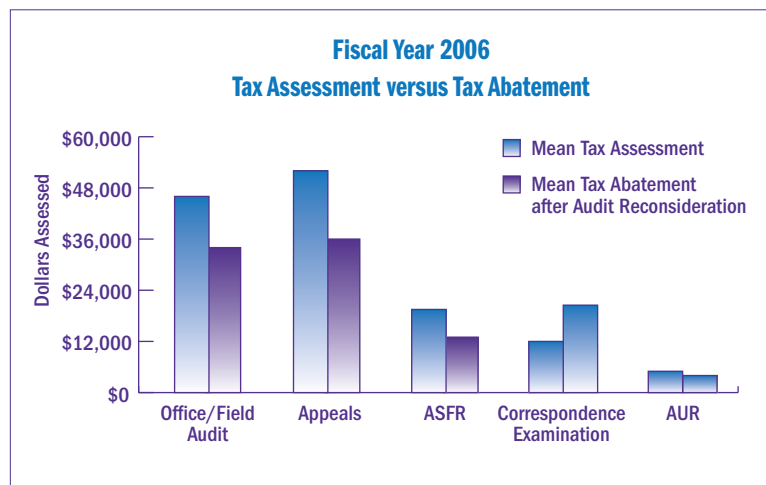
<sup>11</sup> For a detailed discussion of the reasons why taxpayers do not respond to IRS inquiries, see National Taxpayer Advocate 2006 Annual Report to Congress 355-375.

<sup>12</sup> IRM 4.13.1.3 (Oct. 1, 2006).

<sup>13</sup> New court rulings or IRS positions on issues necessitate a request to have new evidence considered. Taxpayers may also locate documentation that was previously not considered by the IRS.

The IRS reports high abatement rates for audit reconsideration requests, especially those originating from correspondence examinations and Automated Underreporter (AUR) notices.<sup>14</sup> The remote and automated examination processes require little human interaction and generate more inaccurate tax assessments.<sup>15</sup>

**CHART 1.19.1, IRS Audit Reconsideration Relief<sup>16</sup>**



Taxpayers contact the TAS for assistance when they disagree with audit assessments and are unable to resolve their issues through normal IRS channels.<sup>17</sup> TAS case advocates work closely with taxpayers, guiding them through documentation requirements as well as the procedures for responding to the IRS. As a result, TAS resolves a large percentage of audit reconsideration cases with partial or full abatement of the underlying tax assessment.

**TABLE 1.19.2, TAS Audit Reconsideration Relief<sup>18</sup>**

Fiscal Year	Number of TAS Case Closures	Percent of Cases with Relief Granted	
		Full	Partial
2004	7,395	52.14%	9.09%
2005	7,276	56.93%	8.53%
2006	8,466	58.22%	8.85%
2007	11,091	71.07%	6.86%

<sup>14</sup> The ratio of audit reconsiderations to the number of examinations is steadily increasing for correspondence examinations. In FY 2006, the number of audit reconsideration cases was almost six percent of total correspondence examinations. This trend suggests an underlying problem with this particular examination process.

<sup>15</sup> IRS, *Enforcement Revenue Information System (ERIS) SDB 721 Database* (Apr. 2007).

<sup>16</sup> *Id.*

<sup>17</sup> Taxpayers must meet TAS criteria in IRM 13.1.7.2.

<sup>18</sup> The TAS case closures were extracted from the Taxpayer Advocate Management Information System (TAMIS) for cases closed in FY 2004, 2005, 2006, and 2007 with a Primary Issue Code 620 (Audit Reconsideration) (Oct. 4, 2007).

The audit reconsideration process is costly and burdensome, both for taxpayers and the IRS. For example, Table 1.19.3 breaks down the average cost per case closure for ASFR examinations and reconsiderations by operating division.

**TABLE 1.19.3, Average Cost Per Closure For FY 2005<sup>19</sup>**

Source	Average Cost Per Closure
SB/SE ASFR Examination	\$18.77
SB/SE ASFR Reconsideration	\$52.30
W & I ASFR Examination	\$23.97
W & I ASFR Reconsideration	\$50.52

Clearly, it is much more cost effective for the IRS and the taxpayer to resolve issues during the initial examination.

### IRS Strategic Goals and The Risk of Harm to Taxpayers

The IRS's goal to reduce cycle time, which stems from the IRS Strategic Plan for FY 2005-2009, can only be accomplished by placing new cases in the pipeline or closing existing cases more quickly.<sup>20</sup> Case closures and cycle time are both key performance measures in Examination,<sup>21</sup> driving management and front line examination activity and ultimately impacting taxpayers. To reduce the number of tax assessments generating audit reconsiderations, the IRS must address the practices and procedures that lead to post-audit disputes.

#### *IRS Internal Guidance that Encourages Early Closure but Does Not Encourage Solving the Taxpayer's Problem Leads to Poor Customer Service.*

The IRS focus on closures and cycle time creates opportunities for employees to close audits prematurely. For example, conflicting guidance in the Internal Revenue Manual (IRM) may contribute to audit reconsiderations. IRM 4.19.3.20.9 (1) b. states that a response is considered "disagreed" when the taxpayer makes any comment that he or she does not intend to waive appeal rights, even if the tax and all penalties have been fully paid. IRM 4.19.13.11, however, states that if a taxpayer remits the correct amount but does not sign the agreement, and the Notice of Deficiency has not been issued, the case is closed as "agreed."

The IRS should clarify a taxpayer's intent upon receipt of payment during an examination. Without confirmation from a taxpayer that issues are agreed, the IRS should not close a case "agreed" and assess additional tax.

<sup>19</sup> IRS Workload Planning and Control Report, *Average Cost to Close Fiscal Year 2005 Nonfiler IMF Modules 2* (Mar. 30, 2007).

<sup>20</sup> IRS, *IRS Strategic Plan 2005-2009* 25.

<sup>21</sup> IRS, *SB/SE Campus Compliance Services Program Letter, Fiscal Year 2007* 9.



IRS guidance on receipt of payments places too much emphasis on case closures and cycle time without giving adequate consideration to resolving taxpayer problems or encouraging employees to use common sense and make the correct decision. As the following examples illustrate, this type of guidance leads to premature case closure and the need for TAS assistance:

- A taxpayer's representative (power of attorney or POA) who was attempting to secure appeal rights for a client contacted TAS. Through the UPS tracking system, TAS verified that the POA had sent a timely protest and a request for an Appeals hearing. The taxpayer sent in a check to stop the interest but did not agree to the audit adjustment or sign the audit report. Examination was in the process of closing the case "agreed" even though a signed audit report was not received. TAS had to convince the Exam manager that the taxpayer's intent in paying the proposed assessment was to stop the interest and the taxpayer should receive appeal rights.
- An IRS employee advised taxpayers not to file an amended return to correct errors once the IRS issued a notice of unreported income.<sup>22</sup> The IRS directs taxpayers to agree with the unreported income, then file an amended return to claim additional expenses against the unreported income.<sup>23</sup>
- A taxpayer received a letter asking for supporting documentation, which the taxpayer provided within the 30 day timeframe specified. The taxpayer later received another letter from Exam advising him of changes to his return without taking into account the information that he had submitted.<sup>24</sup>

A pattern of premature closures prevalent in campus operations led the IRS to issue this IRM procedural update:

If mail is received in the Centralized Audit Reconsideration Unit (CRU) and the first read unit determines that the correspondence was received in examination while the audit was still open, the mail should be returned to the Correspondence Unit that prematurely closed the case, for re-opening. The taxpayer is entitled to all of the benefits derived from an examination no-change.<sup>25</sup>

TAS applauds this directive, and encourages the IRS to incorporate this guidance into the IRM. Despite this acknowledgement that cases are closing prematurely, however, the number of audit reconsiderations continues to grow.

<sup>22</sup> Systemic Advocacy Management System (SAMS) Project No. 26103.

<sup>23</sup> IRM 21.3 Job Aid, CP 2000 (Mar. 2007).

<sup>24</sup> Systemic Advocacy Management System (SAMS) Issue No. 28233.

<sup>25</sup> IRM Procedural Update C IMF 07694 (May 8, 2007).

### *Use of the “Combo” Letter Shortens Response Time, Leading to Incomplete Examinations.*

In calendar year 1998, the IRS created the combination letter to reduce the duration of correspondence examinations (*i.e.*, cycle time). The “combo” letter combined the initial contact letter and an official examination report (explaining the taxpayer’s appeal rights) into one mailing. The new combination letter gave the taxpayer a very compressed timeframe to gather information and respond before the IRS issued a statutory notice of deficiency. If the taxpayer was confused by the combo letter, or otherwise failed to secure and submit necessary documentation within the allotted 30 days, he or she lost the opportunity to request a meeting with the IRS Office of Appeals. Many taxpayers did not realize that the 30-day appeal opportunity period was running while they were providing documentation on the issue to a tax examiner. The result was that examinations would close prematurely, before the IRS considered the documentation the taxpayer provided. Beginning in fiscal year 2005, the IRS eliminated the combination letter for Earned Income Tax Credit (EITC) examinations but still uses the letter for other discretionary work.<sup>26</sup>

The underlying rationale for correspondence examinations depends on the time applied to cases as well as the number of cases that can be closed in a fiscal year. These examinations are designed to be “single” or “limited” issue exams that the IRS feels can be more easily resolved through correspondence than by the more costly face-to-face process. IRS cycle time and closure goals drive the correspondence examination process.<sup>27</sup> For example, correspondence cases are to be resolved within 30 days of receipt, with a goal of maintaining cases in inventory less than 45 days, 95 percent of the time.<sup>28</sup> While the “combo” letter may improve audit cycle time and closures, it may also increase the likelihood of an audit reconsideration.

Although the IRS tracks correspondence examination closures and cycle time, it does not capture related audit reconsideration data such as cycle time and aging of reconsideration cases.<sup>29</sup> When the IRS emphasizes correspondence examination closures without tracking the impact of such emphasis on accuracy and customer satisfaction, it risks rework in the form of audit reconsiderations.

### *Lack of Telephone Contact to Resolve Issues Increases the Likelihood of Rework*

For taxpayers involved in a tax controversy, it is important to have access to a knowledgeable IRS employee who can offer help. In a recent report, the Treasury Inspector General for Tax Administration (TIGTA) stated that increasing personal interaction with taxpayers would allow more taxpayers timely access to information they need to resolve discrepan-

<sup>26</sup> National Taxpayer Advocate 2003 Annual Report to Congress 87-98. For a detailed discussion of the combination letter, see National Taxpayer Advocate 2006 Annual Report to Congress 296-297.

<sup>27</sup> IRS, *SB/SE FY 2008-2009 Plan* 61 (Oct. 2007).

<sup>28</sup> Wage and Investment Division, *Correspondence Imaging System Organizational Transition Plan 1* (Aug. 6, 2002).

<sup>29</sup> SB/SE response to TAS research request (Aug. 16, 2007); W & I response to TAS research request (Aug. 17, 2007).

cies and reach agreement on tax matters.<sup>30</sup> TIGTA found that, “IRS auditors were not attempting to contact taxpayers by telephone when additional information was needed to complete audits, despite the fact that taxpayers provided their telephone number for this purpose.”<sup>31</sup>

The National Taxpayer Advocate’s 2004 EITC Audit Reconsideration Study supports TIGTA’s findings.<sup>32</sup> The study showed that the manner in which the IRS audits low income taxpayers impacts the audit outcomes. One finding revealed that taxpayers who do not respond to IRS contact seem to be deterred by the documentation process, but are no more likely to make errors than other taxpayers who engage in the process. When TAS employees initiated contact with taxpayers by telephone, the likelihood of a taxpayer receiving additional EITC increased significantly. The study showed a clear relationship between taxpayers requesting audit reconsideration and receiving additional EITC and the number of telephone contacts by TAS employees.

The IRS uses automated document matching and correspondence examinations to minimize personnel costs and improve coverage, but these processes lack the personal communication channels many taxpayers need to resolve controversies. For example, the AUR program, which processes millions of tax due notices each year and has the highest volume of audit reconsideration requests, is a correspondence-based process.<sup>33</sup> TAS recently received complaints from volunteers at Low Income Taxpayer Clinics (LITC), citing IRS communication deficiencies in the document matching program. For example, one volunteer noted, “I called PPS (Practitioner Priority Service), and the representative told me that a NOD (Notice of Deficiency) had not been sent. During a subsequent conversation with PPS, I was told that a NOD had been sent (on a date prior to my first call).”<sup>34</sup>

The IRS plans to take advantage of automation to “promote an efficient and paperless process whenever possible.”<sup>35</sup> Planned expansion of document matching programs and correspondence examinations will shift the examination program mix away from personal

<sup>30</sup> Treasury Inspector General for Tax Administration, Ref. No. 2006-40-138, *The Wage and Investment Division Automated Underreporter Telephone Operations Could Improve Service to Taxpayers* 6 (Sept. 13, 2006).

<sup>31</sup> In an earlier report, TIGTA concluded that the remote examination goal of improved customer service through a shorter audit process is not achieved when the IRS misses opportunities to engage the taxpayer in the examination process. Treasury Inspector General for Tax Administration, Ref. No. 2002-40-034, *Implementation of the Remote Examination Toll-Free Telephone Program is Ongoing* 5 (Dec. 2006).

<sup>32</sup> National Taxpayer Advocate 2004 Annual Report to Congress vol. 2, at ii and 35. The National Taxpayer Advocate’s Earned Income Tax Credit (EITC) Audit Reconsideration Study included a random sample of more than 900 EITC audit reconsideration cases closed between July 1, 2002 and January 1, 2003. Ultimately, 679 cases (340 IRS Examination and 339 TAS) were analyzed in detail. The study found 70 percent of the EITC audit reconsideration cases came to TAS for assistance because the taxpayer had not heard from IRS concerning his or her original audit or audit reconsideration request. For the 339 TAS cases, employees made 293 follow-up contact phone calls with the taxpayers and sent 436 follow-up letters. In contrast, of the 340 IRS Examination cases, tax examiners made only six follow-up contact phone calls to taxpayers and sent only 173 follow-up letters during the initial audit process. The likelihood of a taxpayer receiving additional EITC increased with the number of phone calls made by the TAS employees. Overall, of taxpayers who went through the audit reconsideration process and received no phone calls, only 38 percent were awarded EITC. This percentage increased to 67 percent for taxpayers who received three or more calls.

<sup>33</sup> See Most Serious Problem, *Automated Underreporter*, *supra*.

<sup>34</sup> Systemic Advocacy Management System (SAMS) Issue I0027245.

<sup>35</sup> IRS, *SB/SE Campus Compliance Services Program Letter, Fiscal Year 2007* 3.

contact to remote communication.<sup>36</sup> However, this shift may contribute to the already growing volume of audit reconsideration requests and increased TAS involvement in the examination process.

The IRS needs to take into account the positive effect that personal contact has on the outcome of an examination and emphasize telephone contact when warranted.<sup>37</sup> The IRS Campus Compliance Services strategy to improve service and reduce burden to SB/SE taxpayers includes enhanced telephone communication as a priority:

**Enhance Telephone Communication:** We need to take greater advantage of the use of the telephone to resolve taxpayer accounts. This is one of the bigger challenges toward achieving many of our priorities. We need to encourage our examiners to be more willing to use the phone to explain our examination to the taxpayer. By getting more taxpayers to understand and ultimately agree with our determination, we will improve cycle time and customer satisfaction. Customers who agree with our final determination are far more satisfied than those who do not.<sup>38</sup>

While this guidance supports meaningful personal contact with taxpayers when necessary to fully explain the examination process or proposed examination changes, the National Taxpayer Advocate notes that the guidance focuses only on getting taxpayers to agree to the IRS's position. The guidance is not focused on getting to the correct answer, resolving the taxpayer's entire problem, or getting additional information. The National Taxpayer Advocate encourages the IRS to amend this guidance to explicitly state that it is important to communicate to get to the *right* answer, help the taxpayer understand what is necessary for documentation of his or her position, and explain the ultimate results of the examination. Moreover, the IRS should incorporate this guidance into the IRM and allow this approach on a broader basis (*i.e.*, W & I exams).

### ***Lack of Address Searches Beyond Internal IRS Data Lessens the Chance of Establishing Contact with the Taxpayer***

When notices are returned as undeliverable, the IRS uses an address research program which includes updates supplied by the U.S. Postal Service to locate new taxpayer addresses.<sup>39</sup> The National Taxpayer Advocate previously suggested that the IRS make additional efforts to find new addresses for taxpayers whose letters are returned as undeliverable.<sup>40</sup> For instance, the IRS should consider conducting basic Internet research and initiating telephone contact. In addition, if collection personnel can locate taxpayers who previously failed to respond to notices or examination reports, then the examination function should adopt some of the collection procedures that make it possible to locate taxpayers.

<sup>36</sup> SB/SE response to TAS research request (Aug. 16, 2007); W & I response to TAS research request (Aug. 17, 2007).

<sup>37</sup> National Taxpayer Advocate 2004 Annual Report to Congress vol. 2, at 37.

<sup>38</sup> IRS, *SB/SE Campus Compliance Services Program Letter, Fiscal Year 2007 7*.

<sup>39</sup> IRS, *Accurint- Locator Service*, at <http://sbse.web.irs.gov/compliance/ElectronicResearch/Accurint.htm>.

<sup>40</sup> See National Taxpayer Advocate 2006 Annual Report to Congress 355-375.

A TIGTA report on the treatment of taxpayers during campus audits also revealed that the IRS process for locating taxpayers was weak. Many of the correspondence examination closures were traced to taxpayers who never responded to the IRS regarding their examinations. In these situations, the IRS assesses the tax and begins the collection process. TIGTA found no evidence the IRS made telephone contact with taxpayers who did not respond to correspondence.<sup>41</sup> Thus, taxpayers may not have learned about the audit until the assessment was in collection status.<sup>42</sup>

The IRS's ability to locate and engage taxpayers in the audit process is important to an accurate examination outcome and customer satisfaction. When taxpayers call to provide information, discuss the audit process, or ask about documentation requirements, the IRS should take the opportunity to educate the taxpayer and promote voluntary compliance. While it is important for the IRS to monitor cycle time and closures to improve efficiency and effectiveness, there are inherent risks of focusing on these two measures without appropriate allowances for auditor direction, taxpayer needs, and downstream consequences.

### IRS Comments

The IRS audit reconsideration process provides a forum for taxpayers to provide accurate filing information to correct tax assessed due to processes employed by our Correspondence Exam, ASFR, and AUR programs. While audit reconsiderations may also emanate from field examinations, the National Taxpayer Advocate's concerns are more directed to our campus examination programs and the discussion will accordingly focus on the campus programs.

As cited in the National Taxpayer Advocate's report, audit reconsiderations are brought about for a variety of reasons, such as:

- The taxpayer did not receive correspondence from the IRS;
- The taxpayer did not appear for an audit;
- The taxpayer did not understand notices;
- The IRS did not consider documents the taxpayer submitted
- The taxpayer has new evidence to present, or
- The taxpayer lost necessary documents.

The IRS has instituted some process initiatives designed to balance assisting affected taxpayers in meeting their tax obligations while, attempting to further IRS Strategic compliance goals.

<sup>41</sup> Treasury Inspector for Tax Administration, Ref. No. 2000-10-066, *The Internal Revenue Service Can Improve the Treatment of Taxpayers During Service Center Audits* i (Apr. 2000).

<sup>42</sup> National Taxpayer Advocate 2006 Annual Report to Congress 355-375.

### IRS Strategic Goals and the Risk of Harm to Taxpayers

The National Taxpayer Advocate cites IRS internal guidance as a contributing factor which leads to early case closure and does not encourage solving the taxpayer's problem. While the IRS has made some improvements toward reducing the number of post audit disputes, several factors continue to influence our ability to significantly impact the number of reconsiderations. Chief among these factors is the lack of timely taxpayer response to initial notification of return delinquencies.

When the IRS determines that tax returns have not been filed for specific years, a taxpayer is provided a notification of delinquency and asked to file the return, prior to the account being placed in the ASFR work stream. During the ASFR process, the 30 day and 90 day letters, which include a toll-free contact number, are issued. Approximately eight months will elapse from the time of issuance of the 30 day letter before a default assessment is made. The IRS believes that the combined timeframes between the initial delinquency notification and any default assessment provides the taxpayer sufficient time in which to resolve the delinquency issue.

Additionally, in response to a prior National Taxpayer Advocate report citing premature closures in Correspondence Exam cases, the IRS issued IRM guidance concerning mail received in the Centralized Audit Reconsideration Unit (CRU). Specifically, if mail is received in the CRU and the first read unit determines that the correspondence was received in examination while the audit was still open, the mail is returned to the Correspondence unit that prematurely closed the case, for re-opening. The taxpayer is entitled to all of the benefits derived from an examination "no-change".

With respect to the comment that additional clarity is needed in the IRM concerning when a full payment can be inferred as agreement and that this may inadvertently lead to reconsiderations, the two references apply to different processes. The first reference to IRM 4.19.3.20.9 is the process that is followed when a CP2000 notice has been issued and, the second reference, 4.19.13.11, applies to Correspondence Exam. IRM 4.19.13.11 also provides guidelines for when the taxpayer does request an appeal conference. We believe that the instructions contained in the separate IRM provisions are not conflicting but, rather, address the circumstances of each case category appropriately.

Concerning the comment that the IRS directs taxpayers to agree with an unreported income adjustment and file an amended return to claim additional expenses, the primary source for process guidelines is the IRM. Job aids should only be used as accompanying tools to further clarify, or explain IRM processes in simpler terms. IRM 21.3.1.4 4 provides instructions to Customer Service Representatives who receive telephone calls from recipients of CP2000 Notices. The instructions provide an explanation as to why a Form 1040X is not necessary but, does not instruct employees to tell a taxpayer not to file a Form 1040X:

Taxpayer says he/she prefers to file a 1040X instead of responding to CP 2000	Advise taxpayer that it is not necessary to file a Form 1040X and that it could delay the processing of their case. If the taxpayer still wants to file a 1040X, then advise him/her to attach the completed and signed Form 1040X <b>behind</b> the CP 2000 and to mail it to the address of the originating AUR Campus ( <i>not the mailing address where the taxpayer filed their original return.</i> ) AUR will include the Form 1040X in working the response.
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Additionally, if taxpayers insist on filing Form 1040X, AUR caseworkers advise taxpayers to provide any information regarding additional expenses along with the response page of the notice. This is done to ensure the correspondence is routed directly to the AUR operation for processing since a Form 1040X received without the CP2000 may result in the return going through the processing line, further delaying its receipt in AUR. The expenses will be considered by the tax examiner processing the response and no Form 1040X is required.

### Use of the “Combo” Letter Shortens Response Time, Leading to Incomplete Examinations

ASFR and AUR processes do not employ the use of the “combo” letter. We previously tested the use of a 30 day letter for Proof of Concept on EITC examination cases. However, as a result of the test, a research report (Evaluation of Effect of Letter 3826 on Response Rate, dated August 26, 2005) indicated the additional letter did nothing to decrease the non-response rate and conversely, the no reply rate increased by four percent. Therefore, taxpayers who were given additional time to reply did not make use of the additional time. In addition, the extra letter added about 30 days to the average cycle time.

Correspondence Examination has very clear timeframes to allow the taxpayer to either appeal the audit or petition the Tax Court. The taxpayer receives a letter that includes the examination report and is given a 30 day response timeframe. If there is no response from the taxpayer, the case is processed for statutory notice of deficiency (90-day letter). If the taxpayer still does not respond or request an appeal, the case will default and the proposed deficiency will be assessed. All combination letters (Letter 566-B) include Publication 3498-A (Dec. 2006), which fully explains taxpayer appeal rights and timeframes on page 4 of the publication.

For non-EITC (Discretionary Corresponded Examination) issues, the 2006 National Taxpayer Advocate Annual Report conceded a “combo” letter is appropriate when there is a premature withdrawal from an IRA or there is an assessment of unreported self-employment tax. The IRS has third party information for both of these issues. It is the belief of the IRS that taxpayers who have appropriate documentation often respond within 30 days. Once a response is received from the taxpayer, the audit process is stopped until Correspondence Examination has an opportunity to evaluate their documentation.

### Lack of Telephone Contact to Resolve Issues Increases the Likelihood of Rework

The IRS agrees that telephone contact is an important and valuable aspect in resolving taxpayer issues, and has taken several steps to improve communication with taxpayers



impacted by the ASFR, AUR, and Correspondence Examination processes. The IRM 4.19.19 (Jan. 1, 2007), utilized by Correspondence Examination, requires the tax examiner to contact the taxpayer by telephone when evaluating correspondence received and before sending an additional information request letter. IRM 4.19.19 (Jan. 1, 2007) also requires that, whether initiating or receiving calls, tax examiners are to provide complete and accurate assistance and resolve the customer's issue to the extent possible.

Both the ASFR and AUR processes offer a toll free number to all taxpayers to resolve issues identified in a CP2000 notice or 30/90 day letter. Additionally, IRS employees who work ASFR cases are directed to attempt contact with the taxpayer by telephone at least twice before providing a written reply. It is our opinion that every effort is made to inform taxpayers about the ability to call toll free at any time during the audit process in every letter sent. If at any time the taxpayer feels they need personal contact to resolve an issue or receive clarification on an issue, they can use the IRS toll free phone service to receive help. All tax examiners are trained to answer questions regarding the issues under audit.

#### **Lack of Address Searches, beyond Internal IRS Data, Lessens the Chance of Establishing Contact with the Taxpayer**

We agree that the mobility of taxpayers between filing periods continues to present problems with obtaining valid mailing addresses, especially when taxpayers fail to voluntarily provide notification of new addresses to the IRS. On notices returned to the IRS as undeliverable, IRS does perform research on both primary and secondary taxpayers to locate updated addresses through the Integrated Data Retrieval System (IDRS).

In summary, the IRS believes that the greatest impediment to reducing the volume of cases subject to audit reconsideration may be overcome through the continued use of initial contact letters notifying a taxpayer of a delinquent return, and timely responses from taxpayers. We remain committed to exploring any avenues that will assist us in improving the notification and resolution process to the benefit of the taxpaying public while meeting our responsibility to realize compliance goals for all of our programs.

## Taxpayer Advocate Service Comments

### *IRS Strategic Goals and the Risk of Harm to Taxpayers*

The IRS acknowledges its struggle to reduce the number of audit reconsiderations generated by correspondence examination and the ASFR and AUR programs. Although the IRS claims approximately eight months elapse between the issuance of a 30-day letter and a default assessment, the National Taxpayer Advocate continues to receive complaints from taxpayers and their representatives about premature case closures. In a recent issue submission to the TAS Office of Systemic Advocacy, a practitioner reported that the taxpayer timely responded to a request for documentation and the practitioner faxed a power-of-attorney form to represent the taxpayer and spoke to a telephone assistant, yet the IRS still issued a statutory notice of deficiency before reviewing the documentation.<sup>43</sup> The IRS comment that the combined timeframes between initial IRS notification and the default assessment provide the taxpayer sufficient time to resolve the issue is reasonable *if* the IRS acknowledges receipt of the taxpayer's documentation and reviews it. It is unacceptable for the IRS to hold taxpayers accountable for timely responses to the IRS to substantiate an item of income or deduction, and then fail to consider the response before issuing a report and assessing the tax.

The issue of premature notices of deficiency was recently raised publicly by one stakeholder group. In a November 28, 2007 letter to IRS Acting Commissioner Linda Stiff, the president of the National Association of Enrolled Agents (NAEA) expressed concern about recent enforcement efforts, namely, the disturbing trend of the IRS issuing a succession of notices without allowing sufficient time to review and act on taxpayer responses. The NAEA stated that in some cases, the IRS lost responses or claimed not to have received them. Some enrolled agents requested face-to-face meetings to resolve issues and were denied the option. Some filed Requests for Taxpayer Advocate Service Assistance (*i.e.*, Forms 911), claiming the taxpayer suffered harm from the arbitrary tax law administration process. The NAEA also noted that taxpayers may agree to proposed changes just to avoid further enforcement activity, or their representatives may petition the U.S. Tax Court to protect a taxpayer's right to have documentation considered. The NAEA asked the Acting Commissioner to investigate the timing of notices and take appropriate action.

The National Taxpayer Advocate has repeatedly encouraged the IRS to allow more time to associate and consider taxpayer documentation before proceeding with enforcement. The IRS acknowledges that it issues notices prematurely, but says these are isolated instances. Given the important rights and additional costs to the taxpayer triggered by the Notice of Deficiency, it is important that the IRS take all available steps to prevent premature issuance. The IRS undermines taxpayer rights when it fails to associate and consider taxpayer

<sup>43</sup> Systemic Advocacy Management System (SAMS) issue No. I0028246.

responses before proceeding with actions that lead to an assessment of tax. These actions then increase the likelihood of an audit reconsideration.

### *Combination (Combo) Letters Limit Taxpayer Rights*

In past Annual Reports to Congress, the National Taxpayer Advocate has raised concerns about the use of the combo letter in the correspondence examination process and its negative impact on taxpayer rights.<sup>44</sup> The combo letter conflates two separate processes: responding to an examination request for supporting documentation and requesting an appeal. These processes should not be combined because taxpayers may become confused and believe they are mutually exclusive. If the taxpayer wants an examiner to consider additional information, he or she will not request an appeal and may lose appeal rights later. A taxpayer who wants an appeal may stop communicating with the examination function, and the Appeals office will receive an undeveloped case. Either scenario harms taxpayers and creates unnecessary burden.

Giving taxpayers the rights they are due is more important than preventing a 30-day increase in cycle time. Providing an additional 30 days for the taxpayer to respond simply gives the IRS one more opportunity to resolve the case. Taxpayer rights should not be abridged simply for the IRS's convenience or to achieve a cycle time goal. Routine use of the combination letter impairs taxpayer rights and leads to inaccurate audit results. The IRS should work with TAS to review and study how to eliminate combo letters for non-EITC examinations, as was agreed to in 2005.<sup>45</sup>

### *IRM Provisions Promote Premature Closure*

The IRS response regarding separate IRM provisions for processing cases upon receipt of an advance payment or cash bond does not address the disparity between two IRM sections. The National Taxpayer Advocate acknowledges that these are two separate examination program areas. However, the underlying reasons for separate and differing guidance are not clear. If a taxpayer makes an advance payment or posts a cash bond without an affirmative statement or signed agreement regarding a proposed deficiency, the IRS should not assume the taxpayer has agreed to the additional tax, regardless of the source of the case as AUR or correspondence examination. The IRS should clarify the taxpayer's intent before closing a case as agreed.

### *Lack of Telephone Contact to Resolve Issues Increases the Likelihood of Rework*

The National Taxpayer Advocate is pleased that the IRS recognizes the need to improve communication with taxpayers impacted by ASFR, AUR, and Correspondence Examination processes. The ability of taxpayers to reach assistants, however, is dependent on the IRS

<sup>44</sup> National Taxpayer Advocate 2003 Annual Report to Congress 87-98; National Taxpayer Advocate 2006 Annual Report to Congress 296-297.

<sup>45</sup> The IRS agreed to eliminate use of the combo letter for EITC examinations. See National Taxpayer Advocate 2003 Annual Report to Congress 87-98. For a detailed discussion of the combination letter, see National Taxpayer Advocate 2006 Annual Report to Congress 296-297.

level of service on the toll-free lines. For example, in FY 2007, the level of service for AUR inquiries was 74 percent and 70 percent for W&I and SB/SE, respectively.<sup>46</sup> These figures mean that at least one quarter of the taxpayers trying to reach the IRS on that line – and as many as three in ten – cannot get through.

### *Lack of Address Searches beyond Internal IRS Data Lessens the Chance of Establishing Contact with the Taxpayer*

The IRS needs to expand its repertoire of resources to include external data to locate taxpayers. As previously noted, the IRS should consider conducting basic Internet research and initiating telephone contact. Further, if collection personnel locate taxpayers who previously failed to respond to notices or examination reports, then the examination function should adopt the collection procedures.

## Recommendations

The National Taxpayer Advocate recommends that the IRS take the following steps:

- Establish a joint TAS/IRS working group to study the correspondence examination process and address taxpayer and practitioner concerns with premature notices.
- Conduct research with TAS to identify effective use of locator services and other Internet based address searches when taxpayers do not respond to initial audit contacts.
- Immediately cease use of the combination letter except in the two instances the National Taxpayer Advocate agreed to in 2005:
  - ◆ Tax on premature withdrawals from an Individual Retirement Account; and
  - ◆ Self-employment tax on business income.
- Survey taxpayers who completed the audit reconsideration process to determine why the initial audit process failed.
- Establish a measure of overall audit effectiveness that includes audit reconsiderations.
- Study the effectiveness of the mixture of face-to-face versus correspondence examination processes and their related audit reconsideration requests to develop the best approach to maximizing voluntary compliance;
- Review IRS procedures for advance payments and determine if the IRS is justified in closing a case agreed without the taxpayer's signature on a report or other affirmative reply.

<sup>46</sup> See Most Serious Problem, *Automated Underreported Program*, *infra/supra*.

- Make IRM 21.3 Job Aid, CP2000, obsolete since it contradicts IRM 21.3.1.4.4 with regard to advising a taxpayer to file an amended return to claim additional expenses.
- Study the demographics of audit reconsideration cases to determine if there are common issues, procedures, or taxpayer characteristics that can be addressed to relieve taxpayer burden.

MSP  
#20**Audits of S Corporations****Responsible Officials**

Richard J. Morgante, Commissioner, Wage and Investment Division

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division

Deborah M. Nolan, Commissioner, Large and Mid-Size Business Division

**Definition of Problem**

Subchapter S corporations<sup>1</sup> are now the most common corporate entity in the tax system, with over three million S corporation returns filed in fiscal year (FY) 2006.<sup>2</sup> Despite the steady growth in this area in recent years,<sup>3</sup> the IRS is struggling to develop an effective and comprehensive strategy to address noncompliance by S corporations. Some of the challenges facing taxpayers and the IRS include:

- Compliance efforts are often thwarted by the lack of data to assess compliance risks<sup>4</sup> and by poor audit results;
- Undue taxpayer burden results from inefficiencies caused by the S corporation election process and Schedule K-1 matching program errors; and
- Employment taxes attributable to S corporation shareholder wages that are treated as distributions accounted for an estimated \$5.7 billion of the tax year 2000 tax gap.<sup>5</sup>

**Analysis of Problem****Background**

S corporations are incorporated entities with many of the same attributes as traditional C corporations, including limited liability, transferable ownership, and unlimited life span. Unlike C corporations, however, S corporations are generally not subject to income tax.<sup>6</sup> Instead, they “pass through” the profit or loss of the business to the shareholders, who

<sup>1</sup> S corporations are incorporated entities that share many of the same attributes as traditional C corporations, including limited liability, freely transferable ownership, and unlimited life. Unlike C corporations, S corporations pass through income and losses to their shareholders and are subject to tax at the owner level. S corporations do have inherent limitations such as the number and type of shareholders and the requirement of only one class of stock.

<sup>2</sup> In FY 2006, 3,715,249 S corporation returns were filed, accounting for over 60 percent of all corporate returns. IRS, *Data Book 2006* Table 9 (March 2007).

<sup>3</sup> In 1985, S corporations filed only 724,749 returns. See IRS, *Statistic of Income Tax Stats - Integrated Business Data* Table 1 (1980-2002) and IRS, *Compliance Data Warehouse, Business Returns Transaction File* (Tax Years 2003, 2004, and 2005).

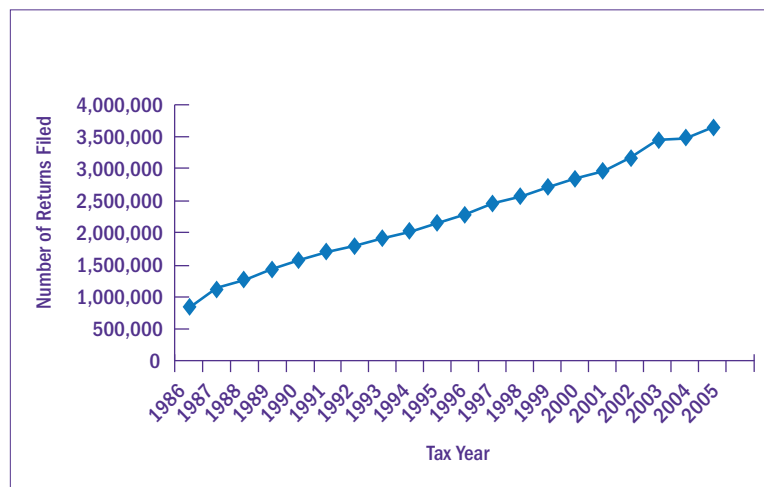
<sup>4</sup> The IRS National Research Program is studying S corporations by examining tax year 2003 and 2004 returns. Results are expected in 2008.

<sup>5</sup> Treasury Inspector General for Tax Administration, Ref. No. 2005-30-080, *Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations 2* (May 2005).

<sup>6</sup> In 1958, Congress established IRC Subtitle A, Chapter 1, Subchapter S to enable small businesses to form corporations that allow pass-through treatment.

report it on their individual returns. To qualify as an S corporation, an organization must be a “small business corporation.”<sup>7</sup> The continual growth in S corporation filings may be due in part to lower individual tax rates inducing many traditional C corporations to elect S corporation status; and the availability of limited liability and the perceived ability to avoid self-employment tax inducing many sole proprietorships to elect S corporation status.

**CHART 1.20.1, S Corporation Filing Growth<sup>8</sup>**



S corporation returns now account for 65 percent of all corporate returns,<sup>9</sup> with 78 percent of S corporation returns reporting assets under \$250,000.<sup>10</sup> In tax year 2005, S corporations reported over \$265 billion in net income.<sup>11</sup>

The growth of S corporations was encouraged by several legislative acts that lowered marginal individual income tax rates, permitted new types and larger numbers of shareholders, and provided special elections for wholly owned subsidiaries.<sup>12</sup> Despite these tax law changes, there are significant tax and non-tax reasons why businesses choose this form of entity.

<sup>7</sup> 26 U.S.C. § 1361. The entity must be a domestic corporation, have only individuals, estates, certain trusts, banks and certain exempt organizations as shareholders, must not have more than 100 shareholders, must have only citizens or residents of the United States as shareholders, and must not have more than one class of stock. The S corporation must file an annual return on Form 1120S, *U.S. Income Tax Return for an S Corporation*, which is due on or before the 15th day of the third month following the close of the corporation's tax year.

<sup>8</sup> IRS, *Statistic of Income Tax Stats - Integrated Business Data Table 1* and IRS, Compliance Data Warehouse, *Business Returns Transaction File* (Tax Years 2003, 2004, and 2005).

<sup>9</sup> IRS, Compliance Data Warehouse, *Business Returns Transaction File* (Tax Year 2005).

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> See generally, Tax Reform Act of 1986: Revenue Reconciliation Acts of 1990 and 1993: Small Business Job Protection Act of 1996: American Jobs Creation Act of 2004.



**TABLE 1.20.2, Issues Affecting Choice of Entity<sup>13</sup>**

Tax Issues	Nontax Issues
Sale of business/liquidation	Limited liability protection
Tax rate exposure	Capital structure
Use of losses	Stockholder and buy-sell agreements
Compensation package	Type of business/investment activity
Complexity	Asset protection planning <sup>14</sup>
State tax issues	State regulatory guidance
	Liquidation rights
	Industry standards and practices
	Franchise, estate and gift taxes

The choice of business structure impacts the liability of the owners, the options available for financing and investing activities, and the future plans of the company. For example, a C corporation is generally the entity of choice if a corporation anticipates a public offering, because S corporations are not permitted to have more than 100 shareholders.<sup>15</sup>

### The IRS Lacks Data to Assess Compliance Risks

Research enables the IRS to develop strategies to address certain areas of noncompliance and improve voluntary compliance. The current National Research Program (NRP) reporting compliance study of approximately 5,000 S corporations filed in 2003 and 2004 will help identify pockets of noncompliance, but the IRS needs ongoing analysis to stay abreast of compliance risks. Developing new tools to detect and deter noncompliance in S corporations is vital to the IRS's overall examination strategy.

### Fewer Asset Categories Identify S Corporations than C Corporations

The IRS stratifies C corporation filings into 13 separate asset ranges. In contrast, nontaxable S corporations (after Jan. 1, 1991) are presently identified on IRS systems under only three asset categories.<sup>16</sup> Isolation of returns with higher compliance risk can be more difficult when the returns are stratified in only three asset ranges, especially when 99 percent of all S corporation returns report assets of \$10 million or less.<sup>17</sup> This limitation reduces the IRS's ability to segregate and test for noncompliance of S corporations in smaller asset ranges as it does for C corporations.

<sup>13</sup> Gregory A. Porcaro, *The Choice of Entity Maize*, *Journal of Accountancy*, Mar. 2007, at 64. See also James E. Brennan, *The Tax Gap, Testimony Before the Committee on Small Business, U.S. House of Representatives* (Apr. 26, 2007).

<sup>14</sup> American Bar Association, *Choosing The Best Entity For Your Firm*, at <http://www.abanet.org/yld/mo/bestentity.shtml>.

<sup>15</sup> Joint Committee on Taxation, Ref. No. JCX-41-06, *Present Law and Background Relating to Selected Business Tax Issues* 9 (Sept. 19, 2006).

<sup>16</sup> The number of categories excludes old activity codes and nontaxable returns processed prior to Jan. 1, 1991.

<sup>17</sup> Treasury Inspector General for Tax Administration, Ref. No. 2006-30-114, *Filing Characteristics and Examination Results for Partnerships and S Corporations* 5 (Aug. 2006). The one percent of returns with assets greater than \$10 million are identified using one asset category, so the remaining 99 percent of returns are divided between two asset categories.

### *Enterprise Risk Is Difficult to Detect*

In addition to the difficulty of working with a smaller number of S corporation asset categories, the IRS is looking at the components of compliance risk in the forms of

- Special Purpose Entities;
- Accommodation Entities; and
- Agents (promoters and preparers).

The IRS increasingly identifies S corporation returns for examination to address abusive tax schemes and avoidance transactions,<sup>18</sup> but identifying compliance risk associated with multi-entity return groups is challenging. Traditional IRS examination techniques focus on examining one taxpayer at a time. Tax avoidance strategies often conceal significant tax issues through the use of multiple levels of flow-through entities.<sup>19</sup> The IRS employs a new tool called YK-1<sup>20</sup> to look for patterns of noncompliance but does not use it extensively and its impact on compliance results is not yet known.

The IRS is also developing a high income taxpayer strategy to test the hypothesis that the highest income strata of Forms 1040, (Individual Income Tax Return) are using a variety of tax products and entity structures to defer tax liability into future years, convert ordinary income into lower capital gain tax income, or offset income with sham losses. The IRS plans to use internal data driven approaches to determine which model or combination of models has the highest classification select rate.<sup>21</sup>

### *Income from Disregarded Entities Goes Undetected*

A disregarded entity<sup>22</sup> is a single member Limited Liability Company (LLC)<sup>23</sup> that has not elected to be classified as a corporation. It is called a disregarded entity because the owner reports business activity as if the entity did not exist. For example, if the single member is an individual taxpayer, LLC transactions are reported on the owner's Form 1040 as if it is a sole proprietorship.

The compliance detection issue results from the owner of a disregarded entity using the tax identification number of an entity that does not have a filing requirement. The IRS document matching program cannot match the disregarded entity income with the true owner and the income may go unreported.

<sup>18</sup> Treasury Inspector General for Tax Administration, Ref. No. 2006-30-114, *Filing Characteristics and Examination Results for Partnerships and S Corporations 2* (Aug. 2006).

<sup>19</sup> Eric Toder, *Reducing the Tax Gap: The Illusion of Pain-Free Deficit Reduction*, Urban Institute and Urban-Brookings Tax Policy Center, (July 3, 2007).

<sup>20</sup> YK-1 is an interactive prototype software tool and database developed and maintained by IRS headquarters research division. The tool draws graphs of links to help visualize complex tax structures.

<sup>21</sup> IRS Flow Through Compliance Committee meeting minutes (July 12, 2006).

<sup>22</sup> Treas. Reg. § 301.7701-2(c)(2).

<sup>23</sup> A limited liability company is a legal entity created under state law and is separate from its owners. It may own property, enter into contracts, and can sue or be sued. Owners are called members and are shielded from the entity's liabilities. All 50 states and the District of Columbia allow the formation of LLCs. Some states allow an LLC to be owned by only one person (a single member LLC). IRM 8.13.1.2.7 (May 2001).

**EXAMPLE:** Mr. Smith forms Safe Insurance, LLC for his insurance business and obtains a federal identification number for it. The LLC may own property, incur debt, enter into contracts, and sue or be sued. For federal tax purposes, the LLC is classified as a disregarded entity because Mr. Smith did not elect to be classified as a corporation. At the end of the tax year, Safe Insurance, LLC receives numerous Schedules K-1 for its share of flow-through entity. Mr. Smith should report all Safe Insurance, LLC income on his Form 1040.<sup>24</sup> However, because the Schedules K-1 are issued in the LLC's name and identification number, the IRS cannot associate the transactions with Mr. Smith and they may not be reported.

For tax year 2003, the IRS profiled entities with "LLC" in their names and with no record of filing to estimate the potential noncompliance in this area. A total of 26,000 LLCs that appeared to be disregarded entities received Schedule K-1, Partner's Share of Income, Credits, Deductions, etc., in tax year 2003, of which 469 were involved in registered tax shelters.<sup>25</sup> The gains and losses of those entities, which may not have been reported by the true owners in tax year 2003, are shown below.<sup>26</sup>

**TABLE 1.20.3, Potential Unreported Gains and Losses of Disregarded Entities**

<b>Total Gains</b>	\$ 8.2 billion
<b>Total Losses</b>	\$ 3.3 billion

If unreported, this income becomes part of the tax gap. The IRS is aware of the potential for unreported income and data limitations impacting this entity,<sup>27</sup> but has not yet implemented the following two recommendations made by the Small Business/Self-Employed (SB/SE) division's Research operation:<sup>28</sup>

- "Require all Single-Member LLCs to file an information return. In doing so, the IRS could capture information on ownership, as well as yearly business activity (Income/Losses)"; and
- "Initiate Fed-State activity leading to the sharing of LLC registrations and ownership transfers. This would allow IRS to more accurately account for the current population of LLCs and to receive information on all future registrations, as well as ownership."<sup>29</sup>

The IRS should implement these suggestions in its efforts to reduce the potential for abuse in this growing entity segment.

<sup>24</sup> Treas. Reg. § 301.6109-1(h)(2)(i).

<sup>25</sup> IRS, SB/SE Research / Philadelphia, *Disregarded Entities (DREs) 7* (Feb. 2006).

<sup>26</sup> *Id.*

<sup>27</sup> The IRS does not have the systemic capability to identify the population of disregarded entities.

<sup>28</sup> IRS, SB/SE Research / Philadelphia, *Disregarded Entities (DREs) iii* (Feb. 2006).

<sup>29</sup> *Id.*

The Commissioners of the Large and Mid-Size Business (LMSB) and SB/SE operating divisions approved the establishment of an enterprise Flow-Through Compliance Committee to address research, compliance risks, and resources associated with the population of flow-through entities. These leaders recognized the challenges of this initiative, as well as their limited authority as a group. The committee is comprised of senior managers and executives from SB/SE, LMSB and Wage and Investment (W&I) operating divisions. While the group envisioned using modeling and data mining techniques, it has yet to complete any substantial work in this area.<sup>30</sup>

### Poor Audit Results Limit the Benefits of Compliance Initiatives

An S corporation faced only a 4 in 1000 chance of being audited in fiscal year 2006 compared to 8 in 1000 for C corporations.<sup>31</sup> Further, the percentage of returns examined with no recommended change was higher for S corporations than C corporations, particularly those audited by correspondence, as demonstrated in the following table:

**TABLE 1.20.4, FY 2006 Percentage of Returns Examined with No Change<sup>32</sup>**

Type of Return	Field Audit No-Change Rate	Correspondence Examination No-Change Rate
Small C Corporation (assets < \$10 million)	36%	35%
S Corporation	41%	58%

Examining compliant taxpayers is an ineffective use of resources and creates undue taxpayer burden. SB/SE conducted a flow-through entity “no change” study and issued a working draft report in September 2006. The study acknowledged that examination plan emphasis has historically centered on taxable returns and that changes are needed to improve the quality of examinations. The study revealed deficiencies in five key areas:<sup>33</sup>

- Proper Disposal Codes;<sup>34</sup>
- Depth and Scope;
- Skills/Experience;
- Return Identification and Selection; and
- Projects and Training Returns.

<sup>30</sup> SB/SE response to TAS research request (July 2, 2007).

<sup>31</sup> IRS Data Book, *Examination Coverage: Recommended and Average Recommended Additional Tax After Examination, by Type and Size of Return, Fiscal Year 2006- Continued*, Table 9.

<sup>32</sup> *Id.*

<sup>33</sup> IRS, SB/SE, *Flow-thru Entity No Change Study*, (Sept. 21, 2006).

<sup>34</sup> The IRS uses disposal codes to identify the outcome of an examination. The primary disposal codes are no change, no change with adjustments, agreed, and unagreed.

The IRS National Research Program (NRP) is studying S corporation returns filed in 2003 and 2004, but final results are not expected until late 2008. IRS reviews of closed NRP cases revealed deficiencies in detection of audit issues on related, prior, and subsequent year returns as well as application of tax law.<sup>35</sup> Comments from the review included:<sup>36</sup>

- Various related entities. The flowchart completed by the auditor was not accurate, causing an inability to determine the relationships.
- Flow-through income from related Form 1065 (U.S. Return of Partnership Income) was not addressed even though it was the primary source of income for the return under audit.
- In two cases reviewed, the sole shareholder was an S corporation, which makes the entity an invalid S Corporation.

The IRS acknowledges that both the “no change” study and the NRP review “revealed a lack of understanding of how to conduct a balance sheet audit in relation to the taxpayer’s accounting system.”<sup>37</sup> Although this observation may be limited to a sample review of cases, the IRS examination function needs to focus on improvement in this area.

When the IRS proposes changes to S corporation returns at the conclusion of an examination, it reports each shareholder’s distributive share of the change as an adjustment to the individual shareholder’s tax return. In addition to acknowledging deficiencies with the audit process, the IRS is unable to measure its effectiveness in S corporation examinations because it does not track the ultimate tax at the Form 1040 level. The IRS records audit results at the S corporation level but never associates them with the tax assessment.

### The S Corporation Election Process Creates Taxpayer Burden

In addition to the compliance risks described above, the IRS needs to focus on reducing taxpayer burden associated with the S corporation election process and the K-1 matching program. Taxpayers and return preparers have identified the S corporation election process as one of the most difficult for eligible small business corporations.<sup>38</sup>

Each year, approximately 700,000 small business taxpayers elect S corporation status by submitting Form 2553, Election by a Small Business Corporation.<sup>39</sup> An eligible entity must file the form on or before the 15th day of the third month of the tax year for which the election is to be in effect.<sup>40</sup> If the election is not filed timely or is incomplete, the taxpayer’s S corporation return is converted to a C corporation return when filed. For profitable

<sup>35</sup> IRS, *NRP S Corporation Study Area Visitation Review Team Results* (Sept. 2006).

<sup>36</sup> *Id.*

<sup>37</sup> IRS, *Flow Through Entity No Change Study 4* (Sept. 21, 2006).

<sup>38</sup> IRS, The Office of Taxpayer Burden Reduction, *S-Corporation Elections*, at <http://www.irs.gov/businesses/small/article/0,,id=146223,00.html>.

<sup>39</sup> IRS, The Office of Taxpayer Burden Reduction, *The Sub-Chapter S Corporation Election*, Summary for Small Business Forum 1 (July 2006).

<sup>40</sup> If the taxpayer cannot meet the deadline for filing their S corporation election, they may file the election late under Revenue Procedure 2003-43, which allows the taxpayer to file the election up to 24 months after the due date.

businesses, this creates a corporate tax liability with no required flow-through income reporting by the shareholders.

In processing years 2005 and 2006, there were 78,597 and 88,672 unpostable S corporation returns (*i.e.*, return cannot post because the S corporation election was not approved), respectively, or roughly 14-16 percent of total new S corporation filings.<sup>41</sup> Approximately 20 percent of S corporation returns are unpostable for multiple years because of missing information or IRS processing errors, which indicates the election process is especially problematic for these taxpayers.<sup>42</sup>

In the 2004 Annual Report to Congress, the National Taxpayer Advocate identified the election process as a small business burden and recommended that Congress “[a]mend IRC § 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.”<sup>43</sup>

In 2006, the IRS Office of Taxpayer Burden Reduction established a project to simplify the S-election process for taxpayers and reduce internal costs associated with processing the requests. Revenue Procedure 2007-62, effective for taxable years that end on or after December 31, 2007, permits late elections of S corporation status in certain circumstances.<sup>44</sup> This procedure should reduce the number of unpostable returns and ease taxpayer burden. The best approach to reducing taxpayer burden, however, is to permit the election to be considered timely filed with the first S corporation return.

### **Schedule K-1 Matching Program Errors Increase Taxpayer Burden**

S corporations file over six million Schedules K-1 each year to report profit and loss to their shareholders.<sup>45</sup> Since tax year 2000, the IRS has input paper Schedules K-1 on computers and combined them with electronically filed Schedule K-1 information for use in the Automated Underreporter (AUR) program.<sup>46</sup> The IRS then matches income and loss information from Schedules K-1 to individual tax returns and generates notices when differences arise.

<sup>41</sup> IRS, SB/SE Research- (St. Paul), *Profile Taxpayers with Unpostable Initial 1120S Returns*, 6 (May 2007) and *Projections and Forecasting Document 6292 Table 1* (Fiscal Year 2006).

<sup>42</sup> *Id.*

<sup>43</sup> National Taxpayer Advocate 2004 Annual Report to Congress 391.

<sup>44</sup> SB/SE response to TAS research request (Aug. 30, 2007).

<sup>45</sup> IRS Document 6961, *Calendar Year Projections of Information and Withholding Documents for the United States and IRS Campuses 4* (June 2006).

<sup>46</sup> See Most Serious Problem, *Automated Underreporter Program*, *supra*.

**TABLE 1.20.5, K-1 Matching Program Notices Issued For All Flow-Through Entities<sup>47</sup>**

Tax Year	Notices Issued	Closed — No Change	Closed — Assessment
2003	129,770	39,843	86,872
2004	133,258	42,245	86,131

Tax law issues and procedures make matching return information difficult for several reasons:

- At-risk and passive activity rules create suspended loss carryovers that can offset current year income;<sup>48</sup>
- Some business deductions are taken at the individual level;<sup>49</sup> and
- Reporting of flow-through income and deductions may occur on different schedules and attachments to an individual's return.

Although IRS employees screen returns in the program to eliminate unnecessary notices, the error rate is still high. The screen-out rate<sup>50</sup> for FY 2006 was 60.3 percent and the no-change rate for the most recent tax year completed (2004) was 32 percent.<sup>51</sup> The IRS implemented additional filters and screening enhancements in 2004 and 2005, but the program continues to experience significant errors that can increase taxpayer burden. For example, the cross-functional Flow-Through Compliance Committee launched a study of invalid Social Security numbers (SSNs) and Employer Identification Numbers (EINs) after discovering that over 800,000 K-1s could not be matched to a valid SSN or EIN in processing year 2002.<sup>52</sup> The IRS reduced the number of Schedule K-1s that cannot be matched, but as shown in Table 1.20.6, the figure remains high.

**TABLE 1.20.6, Schedule K-1s Not Matched to a SSN or EIN<sup>53</sup>**

Form	Processing Year 2004	Processing Year 2005
1065	529,224	448,033
1041	67,237	45,030
1120S	89,184	89,905
<b>Total</b>	<b>685,645</b>	<b>582,968</b>

<sup>47</sup> SB/SE Campus Compliance Services response to TAS research request (July 3, 2007). The 2005 tax year was only partially complete in July 2007. The IRS could not break out Forms 1120S, 1065 and 1041.

<sup>48</sup> At-risk rules limit the amount of losses that can be deducted to the amount a taxpayer has at risk. A passive activity loss occurs when losses from all passive activities exceed income from all passive activities.

<sup>49</sup> For example, charitable contributions and the IRC § 179 depreciation deduction flow through to the shareholders to report at the 1040 level.

<sup>50</sup> Percent of K-1 matching program returns reviewed by IRS employees and resolved prior to taxpayer contact.

<sup>51</sup> SB/SE Campus Compliance Services response to TAS research request (July 3, 2007).

<sup>52</sup> IRS Flow-Through Compliance Committee, *Invalid TIN Recommendation Briefing* at [http://lmsb.irs.gov/hq/srp/downloads/FTCC/Invalid\\_TIN\\_Recommendation\\_Briefing.asp](http://lmsb.irs.gov/hq/srp/downloads/FTCC/Invalid_TIN_Recommendation_Briefing.asp).

<sup>53</sup> SB/SE Campus Compliance Services response to TAS research request (July 3, 2007).



Invalid SSNs and EINs lessen the effectiveness of matching flow-through income and enforcing compliance. Analytical methods and compliance tools such as the YK-1 program and AUR notices are sensitive to the effects of even small numbers of erroneous data.<sup>54</sup>

To reduce errors, the IRS posts tips for accurate Schedule K-1 filing on its website.<sup>55</sup> For example, the site warns taxpayers not to net income against separately stated losses or expenses, and to report deductible basis limitation losses from prior years on a separate line from current year transactions.

TAS dedicates time and resources to the K-1 matching program because taxpayers and practitioners continue to express frustration with the program. Concerns elevated to TAS include:

- IRS campus (processing center) employees do not understand flow-through entities;
- Taxpayers cannot reach campus employees by telephone; and
- The IRS issues erroneous notices because it does not consider amended returns.

IRS employees assigned to the K-1 matching program rely on the Internal Revenue Manual (IRM) and corresponding training material. The tax examining technicians who work discrepancies have limited accounting and tax training.<sup>56</sup> Matching K-1 income to an individual return does not require significant training. However, S corporation returns contain many complex issues that may go undetected if employees are only able to address flow-through income. For example, there are numerous basis issues as well as the officer compensation issue discussed below. These matters are beyond the scope of tax examiner training and may be missed during the matching process.

The K-1 matching program is part of the AUR unit, which limits human involvement in the resolution process. Many taxpayers are unable to reach a trained IRS employee to answer questions concerning mismatched K-1s because the AUR program's level of service is poor and the program has no dedicated line for practitioners.<sup>57</sup> Taxpayers and practitioners need access to knowledgeable IRS employees to deal with the often complex questions regarding S corporation and K-1 matching issues.

In addition to difficulties with assessing compliance risks and reducing taxpayer burden, the IRS continues to struggle with known noncompliance with Social Security taxes in small S corporations. As discussed below, the IRS has failed to establish an effective strategy to resolve this issue, and it continues to drain compliance resources and increase the tax gap.

<sup>54</sup> IRS, SB/SE Research /Seattle, San Jose and St. Paul, *Schedule K-1 Data Transcription Study 5* (Jan. 2005).

<sup>55</sup> IRS, *IRS Offers Tips for Accurate Schedule K-1 Filing*, at <http://www.irs.gov/businesses/small/article/0,,id=137402,00.html>.

<sup>56</sup> General Schedule Series 592 employees are tax examiners. Their training includes basic case analysis and response modules.

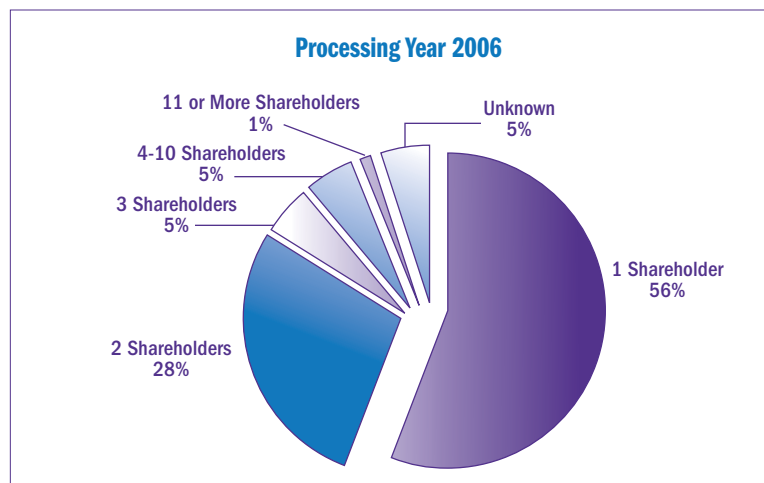
<sup>57</sup> See Most Serious Problem, *Automated Underreporter Program*, *supra*.

### Shareholder Compensation Issue Impacts the Tax Gap

Shareholders earn compensation from services to the corporation and reap the benefits of profitability through corporate distributions. Shareholders of S corporations may serve in key roles of the business, providing management, sales, or service functions, control the day to day activities of the company and make decisions affecting its future.

Most S corporations are owned by one or two shareholders,<sup>58</sup> which indicates that sole proprietorships may incorporate to gain limited liability, and that they favor the flow-through reporting structure.

**CHART 1.20.7, Percent of S Corporations by Number of Shareholders**



The earnings of an S corporation are taxed as ordinary income to its shareholders. Unlike partnership or sole proprietor earnings, however, S corporation earnings are not subject to self-employment tax.<sup>59</sup> This difference in treatment gave rise to a tax planning strategy that treats shareholder compensation payments as distributions of profit to avoid payroll taxes. Under this approach, officer/shareholders take no salary or a nominal salary and receive the remaining compensation as tax-free distributions. The corporation saves payroll taxes and the shareholder ultimately pays only income taxes on his or her share of the corporate profits and avoids paying Social Security and Medicare taxes.

<sup>58</sup> Eighty-four percent of processing year 2006 S corporation returns had one or two shareholders. IRS Compliance Data Warehouse, *Business Returns Transaction File* (Processing Year 2006).

<sup>59</sup> Rev. Rul. 59-221.

**CHART 1.20.8, Percent of S Corporations Reporting No Officers' Compensation**

In tax year 2005 almost one million S corporations with one shareholder paid no officers' compensation.<sup>60</sup> Had all profitable S corporations that reported no officers' compensation been Schedule C businesses, they would have paid an estimated \$4.9 billion in self-employment tax.<sup>61</sup> This disparity is part of the employment tax gap.

The Treasury Inspector General for Tax Administration (TIGTA) reported this strategy in its report on filing characteristics and examination results for partnerships and S corporations. TIGTA wrote, "As we have previously reported, single ownership in an S corporation has the benefit of allowing owners to pay employment taxes on only the portion of profits they decide to pay themselves as salary."<sup>62</sup>

Although the IRS has repeatedly challenged and won the shareholder wage issue in court, it is still used as a tax planning strategy.<sup>63</sup> The IRS continues to audit returns based on this issue and reclassify distributions as wages subject to employment taxes. Establishing a fair and reasonable wage is difficult, time consuming, and requires the IRS examiner to consider:

- The financial condition of the corporation,
- The time worked by the shareholder,
- The company's compensation policy for other workers,
- The salary structure in companies in similar industries, and

<sup>60</sup> IRS Compliance Data Warehouse, *Business Returns Transaction File* (Processing Year 2006). The total count of tax year 2005 one shareholder S corporations with no officer's compensation is 982,480.

<sup>61</sup> *Id.* The estimated total additional self-employment tax for profitable S corporations with no officer's compensation is \$4,898,673,874.

<sup>62</sup> Treasury Inspector General for Tax Administration, Ref. No.2006-30-114, *Filing Characteristics and Examination Results for Partnerships and S Corporations* 6 (Aug. 2006).

<sup>63</sup> See *Radtke, Joseph*, U.S., 895 F.2d 1196 (7<sup>th</sup> Cir. 1990); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90 (9<sup>th</sup> Cir. 1990).

- The return on investment.

The S corporation conversion strategy also fails to recognize that Social Security is an important part of most individuals' retirement income. A taxpayer's Social Security benefits depend on the amount of pre-retirement wages received and social security taxes paid. Return preparers and other business advisors who recommend the strategy to inappropriately minimize or eliminate shareholder wages and maximize distributions to save payroll taxes are reducing the shareholder's future income potential.

The IRS acknowledges the wage issue as a special compliance problem and features it in corporate classification guidelines for Form 1120S.<sup>64</sup> In addition, the IRS now includes a reference to the issue in its notice of acceptance of an S corporation.<sup>65</sup> The IRS has repeatedly litigated the issue and won numerous tax court cases relative to reasonable compensation.<sup>66</sup> In each case, the company president and majority shareholder received distributions that were recharacterized as wages subject to employment taxes. The economic impact of the employment tax strategy affects the tax gap and erodes the Social Security and Medicare tax base.<sup>67</sup> Actions are needed to reverse the trend of electing S corporation status to avoid Social Security taxes.

The National Taxpayer Advocate acknowledges the challenges faced by the IRS in addressing S corporation compliance issues while reducing taxpayer burden. The IRS must find the right balance of research, training, outreach, and compliance activities to improve the quality of S corporation work.

### IRS Comments

A primary challenge in assessing and sizing the extent of noncompliance by S corporations is underscored by the fact that Congress designed S corporations so that they could enjoy the limited liability and governance flexibility advantages of a corporation without being subject to tax at the entity level. Therefore, detection of noncompliance at the S corporation level is exceedingly difficult in isolation from the examination of the tax returns of related parties, such as shareholders.

There are valid, tax motivated reasons to elect S corporation status and these are the reasons Congress enacted Subchapter S in 1958. Some of the advantages of electing S corporation status versus a C corporation include avoidance of double taxation and allowance of losses. The advantages of electing S corporation status versus a partnership include limited liability, greater flexibility for ownership transfer, and less complex tax rules.

<sup>64</sup> IRM 4.1.5.1.14 (Oct. 24, 2006).

<sup>65</sup> IRS Notice CP 261 (Sept. 2006).

<sup>66</sup> See *Veterinary Surgical Consultants, P.C. v. Comm'r*, TC Memo 2003-48; *Nu-Look Design, Inc., v. Comm'r*, T.C. Memo 2003-52; *Superior Proside, Inc. v. Comm'r*, T.C. Memo 2003-50.

<sup>67</sup> Treasury Inspector General for Tax Administration, Ref. No. 2005-30-080, *Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations* 5 (May 2005).

Obviously, avoidance of employment taxes is not one of the reasons S corporations were created and is, therefore, a compliance issue that the IRS continues to address. However, the IRS is not aware of any data to support the assertion that avoidance of self-employment tax is a primary driver of S corporation elections.

### Assessing Compliance Risk

The National Taxpayer Advocate's report points out that there are fewer asset categories for S corporations than there are for C corporations. It then concludes that "this limitation reduces the IRS's ability to segregate and test for noncompliance of S corporations in smaller asset ranges as it does for C corporations."

The IRS agrees that additional stratifications may be helpful in identifying and focusing compliance issues more effectively. For example, profitable S corporations have different issues than loss corporations. However, it is equally important to look at S corporations more universally. Many audits focus on the controlling shareholder since most S corporations are closely held entities and the issues often relate to the shareholder's financial status. It should also be noted that S corporation shareholders are often audited rather than the S corporation in order to limit the amount of losses claimed. S corporations are often placed under examination as a related pick up of the individual shareholder audit.

Items pertaining to S corporations are often adjusted even when the S corporation is not under examination. For example, for an audit of an individual who is claiming an S corporation loss, the issues of basis, at-risk, and passive activity losses are all shareholder issues. They do not require the examination of the S corporation. Many times, the S corporation audit results in a no-change despite the fact that the entire loss was disallowed at the shareholder level. In order to track the shareholder level results from a flow-through entity, Form 1040 Reason Codes were developed. Reason Codes are assigned to issues under examination to determine those that resulted from flow through entities. Reason Codes are used to monitor and track the effectiveness of audits relative to flow through entities. The appropriate use of Reason Codes is discussed further below.

Although the IRS agrees that traditional examination techniques focus on examining one taxpayer at a time, we have altered our approach especially with respect to abusive tax schemes. For example, for certain abusive S Corporation Management Company Employee Stock Ownership (ESOP) arrangements, the IRS examined the S corporation, its ESOP shareholder, the participants of the ESOP, as well as the operating company (or companies) that were the source of the management company revenues. YK-1 analysis provides examiners with a tool to help identify the "enterprise taxpayer." In addition, workshops are held to address the need to look at the "big picture" and to stress the importance of following both the cash and accounting transactions.

The National Taxpayer Advocate's report further states that during the NRP audits, examiners many times failed to consider financial status in the audits of S corporations. The

Internal Revenue Manual has been updated and communications have been sent to examiners to stress the importance of looking at the “big picture”, including the balance sheet, with respect to closely held entities – not just S corporations. The examiner tool kit has also been expanded to include guidance on performing a balance sheet examination.

The IRS continues to address significant issues relating to S corporations as well as other flow through entities through research, training, outreach, and other compliance activities. We have addressed significant tax shelter abuses, addressed officer compensation issues, conducted appropriate training, and conducted the NRP to further assess compliance risks in this area.

The National Taxpayer Advocate’s report includes recommendations and concerns about income from disregarded entities. Although there may be issues associated with identifying the true owner of a disregarded LLC, it is not an S corporation issue. An S corporation is not a disregarded LLC, although it may own one. In addition, a Form 1099 is not required to be issued to any corporate payee so no Form 1099 is required to be issued to an S corporation or a disregarded LLC owned by an S corporation. While we agree that this is a compliance issue, it is not an S corporation issue.

### Audit Results

The National Taxpayer Advocate’s report states that an S corporation faced only a 4 in 1,000 chance of being audited in FY 2006 compared to an 8 in 1,000 chance for C corporations. The IRS believes that this statistic is misleading and does not take into account the various factors used to select an S corporation return for audit. Examiners are trained to look at the “big picture” before placing returns in the audit stream. For example, if the S corporation has losses but the shareholders cannot claim the loss (due to basis, at-risk, or passive activity losses), it is often decided that the S corporation does not warrant examination. Furthermore, examinations of individual returns are often conducted and disallow or limit losses with no impact on the S corporation. We also have an “inadequate compensation” project underway, where related employment tax returns are examined rather than the corporate entity.

The National Taxpayer Advocate’s report indicates that the no change rate for S corporation audits was 41 percent versus 36 percent for small C corporations. To address this issue and concern, the IRS conducted a no-change study in 2006. The study revealed that one of the main reasons for the high no change rate was that examiners improperly coded the returns as no change (since there was no tax due) when there were actually changes made to the return. As a result of this study, additional direction was provided to examiners concerning the proper use of disposal codes.

In addition, the National Taxpayer Advocate’s report stated that the IRS is unable to measure its effectiveness in S corporation examinations because it does not track the ultimate tax at the Form 1040 level. In an effort to address this issue, the IRS developed Reason

Codes in 2005 to assist in tracking the results of flow through entities. A Reason Code is entered by an examiner at the end of the examination to indicate the reason(s) for an audit adjustment. The codes are entered by examiners when adjustments result from a flow through entity to reflect ordinary income or loss and separately stated income or loss adjustments. For example, if interest income that flowed from an S corporation was adjusted, a Reason Code would be entered for the interest adjustment. Similarly, if ordinary income reported on schedule E was adjusted, a Reason Code would be entered for the ordinary income adjustment. For an S corporation, the examiner will enter one of the following reason codes:

24	Due to change in S corp income/(loss) item
27	Due to change in S corp income/(loss) item - NRP

In addition, there are reason codes to reflect adjustments resulting from loss limitations applied at the owner level from a flow through entity:

04	Adjustment to 1040 due to basis limitation on 1120S - NRP
08	Adjustment to 1040 due to at-risk limitation on 1120S - NRP
09	Adjustment to 1040 due to passive activity limitation on 1120S - NRP
34	Adjustment to 1040 due to basis limitation on 1120S
35	Adjustment to 1040 due to at-risk limitation on 1120S
36	Adjustment to 1040 due to passive activity limitation on 1120S

As reflected above, the IRS is able to measure and track the results of S corporation audits. For FY 07, these reason codes were used for over 5,000 Form 1040 closures, and reflect the coverage of S corporation returns.

### *S Corporation Election Process*

The IRS constantly strives to mitigate taxpayer burden. As noted by the National Taxpayer Advocate, in 2006, the IRS Office of Taxpayer Burden Reduction established a project to simplify the S-election process and reduce the number of unpostable returns.

### **Schedule K-1 Matching**

The Schedule K-1 Matching Program relates to a variety of flow through entities, not just S corporations. Flow through entities (including trusts, partnerships and S corporations) provide each beneficiary, partner or shareholder with a Schedule K-1 telling them their distributive share of all flow through items to be reported. It is unclear from the National Taxpayer Advocate's report and statistics cited whether there is a significant problem with the matching of S corporation K-1s. The discussion in the report relates to all flow through entities and we are not able to determine how much of the statistics relate to S corporations versus partnerships or trusts.



Nevertheless, the IRS continues to work to identify program enhancements and eliminate unnecessary notices in the Schedule K-1 Matching Program. As mentioned in the National Taxpayer Advocate's report, tips for accurate reporting of K-1s are included on the IRS web site, and we also implemented additional filters and screening enhancements in 2004 and 2005. We also reach out to practitioners through our outreach and education programs to ensure they have a thorough understanding of the AUR process, including responding to CP 2000 notices.

AUR is a service center compliance activity that matches IRMF data (including W-2s, 1099s, and K-1s) to individual tax returns. Although the matching process is highly automated, tax examiners review individual returns with discrepancies before a notice of adjustment is actually issued to the taxpayer. The IRS disagrees with the National Taxpayer Advocate's statement that the AUR unit limits human involvement in the resolution process. Respondents can reach AUR operations via fax, US mail, and dedicated toll-free lines. Toll-free access is available 12 hours a day, Monday through Friday.

The IRS also disagrees with the National Taxpayer Advocate's statement that many taxpayers are unable to reach a trained IRS employee to answer questions concerning mismatched K-1s because the AUR program's level of service is poor and the program has no dedicated line for practitioners. The AUR program Level of Service (LOS) in SB/SE, that handles K-1 issues, maintains a 70-75 percent LOS rate, which is consistent with our target and agency standard. In addition, a toll-free change request has been submitted to provide practitioners with priority service when dialing into the AUR toll-free line.

### Shareholder Compensation

The issue of compensation to an officer or shareholder is an issue the IRS continues to encounter. The statutory provisions for S corporations state that S corporation shareholders do not pay self-employment tax and the shareholder's compensation for services are wages. As a result, some taxpayers may structure their business as an S corporation to avoid employment taxes. However, we do not believe that this is the primary reason for electing S corporation status.

The National Taxpayer Advocate's report states that if all profitable companies reported income as if they were Schedule C businesses they would pay an estimated \$4.9 billion in self-employment tax. This estimate may be somewhat misleading. It is unclear whether S corporations with losses were included in the computation and used to reduce the amount of income subject to self-employment tax. It is also unclear whether the computation considered the fact that many shareholders are paid wages from a different employer and accordingly, not all of the earnings would be subject to self-employment tax. Additionally, not all of the income would necessarily be considered earned income—for example, some of it could be rental income.

The report states that “[a]lthough the IRS has repeatedly challenged and won the shareholder wage issue in court, it is still used as a tax planning strategy. The IRS continues to audit returns based on this issue and reclassifies distributions as wages subject to employment taxes. Establishing a fair and reasonable wage is difficult and time consuming...”. As previously mentioned, the IRS has an “inadequate compensation” project underway to address this compliance issue. Although we agree this is a compliance challenge, there is little that can be done outside of legislative changes. We continue to address significant issues relating to S corporations as well as other flow through entities through research, training, outreach, and other compliance activities.

In summary, and in response, the IRS will take the following actions:

- Analyze the data from the NRP 1120 S study and develop alternative treatments as warranted;
- Continue to develop, revise, and issue guidance relating to S corporations issues;
- Provide practitioners with priority service when dialing into the AUR toll-free line once the toll free change request is established;
- Continue to update the Internal Revenue Manual as necessary to stress the importance of scrutinizing closely held entities, not just S corporations; and
- Continue to provide training as deemed appropriate relative to S corporations and other closely held entities.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS has provided such a thoughtful and informative response on this important topic. We agree that there are valid business reasons to choose the corporate form of entity and tax advantages to electing S corporation status. However, noncompliance at the S corporation level should be analyzed in addition to related issues peculiar to flow-through entities, such as shareholder loan repayments and basis. The IRS states that “detection of noncompliance at the S corporation level is exceedingly difficult in isolation from the examination of the tax returns of related parties, such as shareholders.” However S corporations, like C corporations, report revenue and operating costs in much the same manner, and detection of noncompliance at the corporate level is therefore very similar.<sup>68</sup> The differences in tax treatment at the shareholder level can be isolated from the corporate entity tax issues.

<sup>68</sup> For example, both C and S corporations may report expenses such as cost of goods sold, depreciation, and repairs and maintenance. These operating expenses are examined at the corporate entity level, without regard to the type of entity.

### *Assessing Compliance Risk*

The IRS agrees with the National Taxpayer Advocate that additional asset categories for S corporations are helpful in applying examination resources more effectively. Related examinations (*e.g.*, shareholders, employment taxes) often reveal significant compliance issues, even when the S corporation audit results in no-change. In addition, the IRS altered its traditional examination focus on examining one taxpayer at a time to address abusive tax avoidance arrangements. For example, the IRS examined the S corporation, its Employee Stock Ownership (ESOP) shareholder, the participants of the ESOP, and the operating company involved in an abusive transaction to effectively enforce compliance. This enterprise approach to auditing all S corporations is key to effective compliance strategies.

The National Taxpayer Advocate supports the IRS emphasis on training to enhance the quality of S corporation examinations and urges the IRS to further its research of disregarded entities to detect noncompliance. The National Taxpayer Advocate recommends that IRS engage in state initiatives for sharing registration information that could lead to identification of entities with unreported income.

### *Audit Results*

The IRS believes the S corporation audit coverage (4 out of 1,000) statistic is misleading because it does not take into account decisions made to forgo an S corporation audit in favor of auditing related shareholder returns. This statistic may not accurately reflect an S corporation's chance of being audited; however the IRS has no better method for measuring its coverage of S corporation returns.

The National Taxpayer Advocate applauds the IRS no-change study that led to field guidance on the proper use of disposal codes. Because the IRS believes the high no change rate is inaccurate due to improper coding on closed cases, it should review this coding on a sample of cases submitted for closure and perfect the data.

The National Taxpayer Advocate is also pleased that the IRS recognizes the need to better measure S corporation audit results and developed reason codes to track the results; however, the reason codes have limited usefulness. For example, only a shareholder's ownership percentage change in S corporation income or loss and loss limitations applied at the shareholder level are tracked. There are other issues with no reason code, such as separately stated items of income and deductions. Also, if this method for measuring audit results does not capture and calculate the ultimate tax results of S corporation audits, the IRS cannot determine the effectiveness of the audits or truly measure voluntary compliance. The IRS should develop a process to track more potential flow-through adjustment categories as well as the ultimate tax impact at the shareholder level that can be used to produce an enterprise return on investment calculation.

### *Schedule K-1 Matching*

The National Taxpayer Advocate agrees that the Schedule K-1 Matching Program relates to a number of flow-through entities, including S corporations. The IRS was unable to provide a breakdown of notices by flow-through entity, which the National Taxpayer Advocate agrees would provide more detailed information on the effectiveness of the program.

We believe that the AUR unit that oversees the Schedule K-1 Matching Program limits human involvement in the resolution process, and we have separately addressed in this report concerns with AUR's level of service and aged responses to taxpayer written inquiries.<sup>69</sup> The IRS response that a 70-75 percent level of service rate is consistent with its target and agency standards represents an attitude of complacency, because the level of service for all other IRS toll-free lines is significantly higher.<sup>70</sup> Even at a 75 percent level of service, one out of every four taxpayers cannot get through to an assistor. The IRS should strive to improve customer service and utilize the most effective approach to resolving K-1 Matching Program errors. Due to the complexity of S corporation issues, the IRS needs trained technical employees to resolve many discrepancies. The IRS plans to provide practitioners with priority service when contacting the AUR toll-free line, which may help to resolve notice errors more quickly as long as the IRS staffs the line with knowledgeable employees. But unless the level of service goes up, this will harm taxpayers without representation, as they will have a lower priority for access to service.

### *Shareholder Compensation*

The National Taxpayer Advocate does not imply that avoidance of employment taxes is a primary driver of S corporation elections, but rather states that it is one motivating factor for electing S corporation status. The calculation of potential lost revenue due to this issue is based on S corporations reporting profits and utilizes all available data. The IRS agrees that the shareholder compensation issue continues to drain resources and believes that little can be done without unspecified legislative changes. The National Taxpayer Advocate disagrees with this approach and urges the IRS to develop a strategy of outreach, education, and enforcement to reduce the occurrences of this issue.

## Recommendations

The National Taxpayer Advocate recommends that the IRS take the following actions:

- Expand classification criteria to include high income individual taxpayers with flow-through income or losses.
- Conduct additional research at the Form 1040 level to assess compliance risk of tiered entities.

<sup>69</sup> See Most Serious Problem, *Automated Underreporter Program*, *supra*.

<sup>70</sup> See *Id.*

- Establish cross-functional teams of revenue agents of various grade levels to conduct enterprise examinations.
- Increase the number of S corporation asset range codes to enhance classification and return selection. Because over 78 percent of S corporation filings report assets under \$250,000, additional strata for this segment of the population could yield valuable workload selection information.
- Validate Schedules K-1 as returns are filed to eliminate unnecessary notices.
- Address disregarded entities by initiating a Fed-State initiative for sharing LLC registrations.
- To address the shareholder wage issue, initiate an outreach campaign that addresses factors considered in establishing reasonable compensation. This campaign should include factors such as time spent working for the business, minimum salary versus distribution ratio, comparable salary to highest paid employees, and salary set by an objective board of directors.<sup>71</sup>
- Conduct a “soft contact letter” study of single shareholder S corporations with no officer’s compensation to test for awareness of the issue and behavior changes in future tax periods.
- Enhance the reason code tracking system to assess the final **tax effect** of S corporation adjustments and related issues (*e.g.*, basis, employment tax, etc.).
- Establish an enterprise S corporation “touch” measure to provide more detailed coverage data. In addition, such measure may have an indirect effect on compliance when taxpayers know the increased risk of examination at one level or another.

<sup>71</sup> These multi-factor tests to evaluate the reasonableness of compensation should be considered from the perspective of a hypothetical independent investor. *Metro Leasing and Development Corporation v. Comm’r.*, 376 F.3d 1015 (9<sup>th</sup> Cir. 2004).

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## FPLP Levies on Social Security Benefits

## Responsible Official

Richard J. Morgante, Commissioner, Wage and Investment Division

## Definition Of Problem

Over the past several years, the National Taxpayer Advocate has expressed serious concern about the IRS's administration of the Federal Payment Levy Program (FPLP).<sup>1</sup> In the 2006 Annual Report to Congress, she gave the IRS specific recommendations to reduce the impact of this program on taxpayers who depend on Social Security benefits for their health and welfare.<sup>2</sup> Although the IRS agreed to conduct additional research to address the National Taxpayer Advocate's concerns, these efforts are not keeping pace with the rapid increase in FPLP levies on taxpayers' Social Security benefits. In fiscal year (FY) 2007, the IRS received in excess of 1.74 million levy payments that attached to taxpayers' Social Security benefits — an increase of almost 24 percent from FY 2006.<sup>3</sup> Moreover, 86 percent of all FPLP levy payments received were associated with benefits which in many cases may represent a taxpayer's primary or *only* source of income.<sup>4</sup>

The National Taxpayer Advocate is particularly troubled that the IRS has yet to develop an automated process to screen out low income or other taxpayers who are experiencing economic hardship from the FPLP. On the contrary, the IRS is actually seeking to expand the FPLP to include other federal payment sources commonly associated with a taxpayer's sole or primary source of income, as well as considering possible means of recouping the fees associated with such levies. In light of these developments and the IRS's plans for the program, it is apparent that FPLP has reached a critical state and warrants immediate attention.

<sup>1</sup> See National Taxpayer Advocate 2001 Annual Report to Congress 202-209; National Taxpayer Advocate 2003 Annual Report to Congress 206-212; National Taxpayer Advocate 2004 Annual Report to Congress 26-263; National Taxpayer Advocate 2005 Annual Report to Congress 123-135; National Taxpayer Advocate 2006 Annual Report to Congress 110-129 and 141-156. IRC § 6331(h)(2)(A).

<sup>2</sup> National Taxpayer Advocate 2006 Annual Report to Congress 110-129 and 141-156.

<sup>3</sup> IRS, Wage and Investment Division spreadsheets, *FPLPMonthlyCountsFY2007* and *FPLPMonthlyCountsFY2006*. [1,740,728 (total number of FPLP SSA levy payments received in FY 2007) - 1,408,330 (total number of FPLP SSA levy payments received in FY 2006) = 332,398; 332,398/1,408,330 = .236 (24 percent)]. Since FPLP levies are continuous and payments may be received monthly until the taxpayer's account is resolved, it should be noted that in FY 2007 these levy payments were associated with a total of 265,009 taxpayers.

<sup>4</sup> IRS, Wage and Investment Division spreadsheet, *FPLPMonthlyCountsFY2007*. [1,740,728 (total number of FPLP SSA levy payments received in FY 2007) / 2,014,142 (total number of FPLP levy payments received in FY 2007) = 86.4 percent (86 percent)].

## Analysis of Problem

### Background

The Federal Payment Levy Program is an automated system that matches IRS records against those of the government's Financial Management Service (FMS) and allows continuous levies to be issued for up to 15 percent of federal payments due to taxpayers who have unpaid federal tax liabilities.<sup>5</sup> While FPLP levies can attach to a variety of federal sources of income, ranging from salaries to retirement income to federal contractor (or vendor) payments, the bulk of all FPLP levy payments received have historically been related to Social Security benefits. Although the IRS initially utilized an income filter to systematically exclude from the FPLP those taxpayers with income below a specified threshold, the IRS gradually phased out the filter and eliminated it altogether in January 2006.<sup>6</sup> The IRS did so in response to a 2003 General Accounting Office (GAO, now the Government Accountability Office) study that concluded the filter was an "inaccurate indicator of a taxpayer's ability to pay."<sup>7</sup> Thus, since January 2006, there has been no FPLP filter for taxpayers with low levels of income.

As the National Taxpayer Advocate pointed out in the 2006 Annual Report to Congress, the law limits FPLP levies to only 15 percent of each Social Security payment, but the remainder may not be enough to avoid a financial hardship, considering that (data updated for 2007):

- Social Security provides at least half of the total income for 65 percent of beneficiaries aged 65 or over, and comprises 90 percent or more of total income for more than 34 percent of this population;<sup>8</sup> and
- As of August 2007, Social Security recipients received an average benefit of \$962.70 per month. An FPLP levy would reduce the amount to \$818.29.<sup>9</sup>

Accordingly, in the 2006 Annual Report, the National Taxpayer Advocate specifically recommended the IRS should:

- Conduct the research necessary to implement an effective filter to screen out taxpayers who are unable to pay from the FPLP;<sup>10</sup>

<sup>5</sup> IRC § 6331(h)(2)(A), as prescribed by the Taxpayer Relief Act of 1997 (Public Law 105-34) Section 1024, authorizes the IRS to issue continuous levies on certain federal payments. The FMS is the Department of Treasury agency that processes payments for various federal agencies. Payments subject to FPLP include any federal payments other than those for which eligibility is based on the income or assets of the recipients.

<sup>6</sup> This filter was known as the Total Positive Income (TPI) indicator and was implemented in January of 2002 at the request of the National Taxpayer Advocate. For a more detailed discussion of this filter, see National Taxpayer Advocate 2001 Annual Report to Congress 202-209; National Taxpayer Advocate 2003 Annual Report to Congress 206-212; National Taxpayer Advocate 2004 Annual Report to Congress 246-263; and National Taxpayer Advocate 2005 Annual Report to Congress 123-135.

<sup>7</sup> General Accounting Office, GAO 03-356, *Tax Administration, Federal Payment Levy Program Measures Performance and Equity Can Be Improved* 11 (Mar. 6, 2003).

<sup>8</sup> Social Security Administration, *Fast Facts & Figures About Social Security*, 2007 (Sept. 2007).

<sup>9</sup> Social Security Administration, Office of Policy, Research, Evaluation and Statistics, *Monthly Statistical Snapshot*, Table 2, Social Security Benefits (Aug. 2007). [ $\$962.70 \times 0.15 = \$144.41$  and  $\$962.70 - \$144.41 = \$818.29$ ].

<sup>10</sup> National Taxpayer Advocate 2006 Annual Report to Congress 128.



- Remove all FPLP cases from its Private Debt Collection (PDC) initiative;<sup>11</sup> and
- Develop procedures in conjunction with the Social Security Administration (SSA) to ensure FPLP levies are released in an expedited manner where failure to do so will cause financial hardship.<sup>12</sup>

In its response to these recommendations, the IRS committed to begin a research project to determine whether effective income and hardship filters could be created and implemented. The IRS also committed to work with the SSA to improve the FPLP program, specifically to identify Social Security recipients who could be experiencing hardship, and block FPLP on benefit payments going directly to a health care facility.<sup>13</sup> The National Taxpayer Advocate was pleased to learn of the IRS's willingness to undertake these initiatives, particularly since TAS was asked to be an active participant in the research effort.

For the purpose of this report, we will renew our focus on the status of the IRS's response to the 2006 recommendations, and will address other FPLP issues that arose in FY 2007.

### Current Status of FPLP Filter

In January 2007, the IRS (specifically Wage and Investment (W&I) Compliance) and TAS established a task force to explore new FPLP enhancements. The goal of this research was to determine if a statistical analysis of data available to the IRS would support the development of a filter, which would distinguish between hardship and non-hardship cases with a high degree of accuracy.<sup>14</sup> To conduct the necessary analysis, W&I agreed to provide data for taxpayers who had outstanding IRS debts and SSA income, and were eligible for FPLP levies.<sup>15</sup> The IRS and TAS would then research these accounts to attempt to identify taxpayer or return characteristics that correctly filtered cases into the hardship or non-hardship group. The key data sources to be considered were the taxpayer's actual tax return and income documents reported to the IRS by third parties.<sup>16</sup> After gathering and reviewing such information, the analysis would attempt to classify assets based on their liquidity. W&I would then develop filters, with TAS Research helping to evaluate their effectiveness.

In September 2007, W&I Research completed its summary findings and shared them with TAS Research. However, because TAS was not comfortable with some of the methodology, W&I agreed to continue work on the filter models with TAS's assistance. Although the National Taxpayer Advocate does not want to rush the IRS into an ill-informed decision,

<sup>11</sup> National Taxpayer Advocate 2006 Annual Report to Congress 128

<sup>12</sup> *Id.* at 156.

<sup>13</sup> *Id.* at 125.

<sup>14</sup> IRS, *W&I Research Prospectus* (Apr. 18, 2007).

<sup>15</sup> *Id.* The study contained FY 2007 (Oct. 2006 to Mar. 2007) dispositions of FPLP cases and active FPLP SSA data for the same period of time.

<sup>16</sup> *Id.* This includes a review of information from a taxpayer's tax return or third party records such as total income, interest or dividend income, mortgage interest and property taxes, and associated schedules (e.g., Schedule A, C, D and E) filed with the return.

the IRS must give this research effort its utmost priority to alleviate the growing problems wrought by FPLP.

### IRS Interactions with the SSA

As agreed previously, the IRS also informed TAS of a discussion it held with SSA on January 23, 2007.<sup>17</sup> The purpose of this discussion was to determine whether it was possible to identify taxpayers or beneficiaries who would be at risk of a financial hardship due to a tax levy, particularly those identified in SSA records as living in nursing homes or assisted living facilities.<sup>18</sup> While the initial dialogue seemed promising, the end result was that the SSA indicators had no correlation in determining whether a taxpayer was low income or not. The SSA also informed the IRS that if additional programming was required, the IRS would have to pay for use of the indicators.

Perhaps because of these conversations or a reluctance to explore other options, the IRS has had no additional contact with SSA. Likewise, the IRS did not acknowledge any efforts to work with SSA regarding expeditious levy releases but did note that its current process already includes a way for the SSA and IRS to take these actions without delay. Unfortunately, TAS continues to receive feedback from taxpayers and practitioners that tells us otherwise. A review of TAS cases shows it is not uncommon for the IRS to receive multiple FPLP levy payments prior to release of the actual levy. This should not be the case. The National Taxpayer Advocate emphatically reiterates the need for a closer look at the current process.

While it is encouraging that the IRS is studying FPLP filters and did initiate conversations with SSA to discuss existing indicators, this is simply not enough given the negative impact of FPLP levies on taxpayers and the IRS alike. The number of FPLP SSA levy cases has more than doubled from FY 2005 to FY 2007, and TAS is still routinely called upon to assist taxpayers experiencing hardship because of IRS actions.<sup>19</sup> Moreover, the relief rates for FPLP SSA levy cases indicate that nearly three out of four cases receive some type of relief from their hardship (*i.e.*, levy release or removal from the FPLP process).<sup>20</sup>

When considering that it takes an average of nearly 15 hours for a TAS employee to resolve an FPLP case, and the IRS must also expend additional time and paperwork to grant such relief, the inefficiency is evident.<sup>21</sup> However, if a suitable filter could stop these levies and resulting hardships from occurring, the need for TAS involvement and IRS work and rework would be minimal.

<sup>17</sup> IRS, W&I response to TAS research request (July 10, 2007).

<sup>18</sup> *Id.*

<sup>19</sup> TAS FPLP cases grew from 1,707 in FY 2005 to 3,474 in FY 2007. Taxpayer Advocate Service, *Business Performance Management System* (Sept. 30, 2007).

<sup>20</sup> Taxpayer Advocate Service, *Business Performance Management System* (Sept. 30, 2007).

<sup>21</sup> Taxpayer Advocate Management Information System (TAMIS) data (FY 2001- FY 2006) for FPLP cases. This calculation reflects the average time to work a non-Earned Income Tax Credit (EITC) case.

## New FPLP Initiatives Signal Even More Trouble Ahead

### *Expansion of FPLP to Other Federal Payment Sources*

Instead of fixing the existing problems and focusing on the appropriateness of accounts relegated to FPLP, the IRS has continued to move forward with expansion of the program. In May 2006, TAS first learned of the IRS's plan to add Railroad Retirement Benefits (RRB) to the FPLP.<sup>22</sup> The IRS noted that a previous GAO report on FPLP estimated the move would potentially affect about 2,300 taxpayers and the average FPLP levy payment would be around \$180 (meaning the average annual RRB payment equates to approximately \$14,000).<sup>23</sup> The National Taxpayer Advocate quickly urged the IRS to reconsider this decision, and shortly thereafter, the IRS agreed to place the expansion on hold until it developed a suitable filter.

However, TAS's concerns resurfaced when we discovered the IRS seems poised to move forward with continued expansion of FPLP levies to RRB as well as other federal payments usually associated with individual taxpayers. These payments include but are not limited to:

- Defense Finance and Accounting Service (DFAS), *e.g.*, federal civilian employee salaries under the:
  - ◆ Department of Energy
  - ◆ Environmental Protection Agency (EPA)
  - ◆ Department of Health and Human Services (HHS)
  - ◆ Veterans Administration (VA)
- Department of Defense (DOD) civilian employee salaries; and
- Military Retirement Annuity Income.<sup>24</sup>

The IRS is tentatively scheduled to add these payments to FPLP as early as March of 2008. TAS only received word of these plans through a research request submitted to the IRS for an update of our 2006 Annual Report recommendations.

While there are marked distinctions between salaries/wages and RRB/military retirement annuity income (which is more like SSA benefits), it stands to reason that an FPLP levy on either type of income will produce more profound economic harm than a regular levy. Whereas the regular levy process allows for someone to personally review the facts of the case prior to imposition of the levy (*i.e.*, to screen out the case), with FPLP there is

<sup>22</sup> IRS, Wage & Investment Division, *Compliance (F&PC) Operational Review* (May 2006).

<sup>23</sup> *Id.*

<sup>24</sup> IRS, W&I responses to TAS research requests (July 10, 2007 and Sept. 25, 2007). TAS also notes that several other FPLP initiatives not listed involve vendor payments which are generally associated with government contracts for services to be provided by a federal contractor. The National Taxpayer Advocate takes no issue with expansion in these areas, and supports IRS efforts to address the problem of federal contractor non-compliance. In fact, we noted this as one of the most serious problems facing taxpayers in the 2004 Annual Report to Congress because it contributes to the growing federal tax gap, and allows for an inherent unfairness when those who "reap the benefits of Federal contracts" refuse to fulfill their federal tax obligations. See National Taxpayer Advocate 2004 Annual Report to Congress 246-263.

no human element, only automation. Quite simply, if there is a match with FMS and all required notices have been sent, an FPLP levy is issued. Thus, there is a greater likelihood of harm and a greater likelihood of taxpayer and IRS downstream burden. Therefore, the National Taxpayer Advocate opposes the addition of any payments commonly associated with a taxpayer's sole or primary source of income, without a suitable filter that first considers the taxpayer's characteristics.

### Increased Cost of FPLP

#### *FMS Fees Associated with Processing FPLP Levies*

To expand and maintain FPLP activities, there are several significant costs that must be considered. To administer the FPLP process, the IRS incurs a sizeable expense to the FMS,<sup>25</sup> which charges a fee for *each* levied payment processed for the IRS.<sup>26</sup> The current charge to the IRS is \$10.20 per transaction, which is expected to rise to approximately \$12.65 for FY 2008.<sup>27</sup> The IRS presently pays this cost out of its annual discretionary appropriations.<sup>28</sup> To cover its FY 2007 costs, the IRS received approval to allocate \$9.8 million of the discretionary appropriations to fund the FPLP program and associated FMS fees. In light of the fact that the program had collected \$860 million since its implementation in July 2000, the funding was easily approved.<sup>29</sup>

The IRS projected its FPLP transactions would rise from slightly less than two million in FY 2007 to nearly three million by FY 2009.<sup>30</sup> Yet, only the addition of DFAS payments was noted in the IRS's explanation of the planned increase.<sup>31</sup> By adding DFAS to the equation (960,000 additional transactions per year) and factoring in the increased FMS fee, the IRS computed its FY 2009 FPLP cost to be nearly \$47 million.<sup>32</sup> Thus the IRS sought an additional \$37 million in its appropriation request sought an additional \$37 million to cover the deficit. Clearly, growth in the FPLP program has continually increased its cost.

#### Proposals to Address Increased Cost of FPLP

A recent Treasury proposal would have allowed FMS to add the cost of its collection services to the liability being recovered from the taxpayer and retain that portion of the levied

<sup>25</sup> FMS matches federal tax debts against certain federal payments that are processed through its Treasury Offset Program (TOP) and subsequently remits the appropriately determined payments to the IRS.

<sup>26</sup> 31 USC §1535 (the Economy Act). Due to limitations in the Economy Act, FMS cannot charge more than its actual costs.

<sup>27</sup> The total FY 2007 cost for FMS fees (to process FPLP levies) was \$20.4 million. TAS also notes that taking into consideration the current FMS rate of \$10.20 and the average FPLP SSA levy payment of \$142.27, the fee equates to over seven percent of the amount levied. Moreover, once the fee rises to \$12.65, it will equate to almost nine percent of the amount levied. IRS, Wage and Investment spreadsheet, *FPLP Monthly Counts FY2007*; W&I response to TAS research request (Oct. 25, 2007).

<sup>28</sup> IRS, W&I, *Proposed FY 09 Budget Initiatives* 8, 9.

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

funds, thereby shifting the cost of collection to the delinquent taxpayer.<sup>33</sup> This change was suggested to “offset the increased direct spending by FMS for the administration of the tax debt program.”<sup>34</sup> However, this process would have unjustifiably treated FPLP taxpayers differently from taxpayers encountering other types of levies where no processing fee applies. To date, Congress has not adopted this recommendation. The National Taxpayer Advocate opposes such a proposal since it would adversely impact a highly sensitive class of taxpayers (*i.e.*, Social Security recipients) who are levied through FPLP.

### IRS Could Improve its External Communications Regarding FPLP

Although the IRS does issue an additional notice to all FPLP taxpayers prior to the actual levy, it should provide more proactive communication and outreach about FPLP, particularly to those taxpayers receiving SSA benefits.<sup>35</sup> Historically, TAS has stepped in to fill the void by publishing a brochure with a clear and concise explanation of how FPLP works and by offering various outreach opportunities through its Low Income Taxpayer Clinic (LITCs) program. TAS has also created a Tax Toolkit, which is now available to all taxpayers via the internet and includes specific information regarding FPLP.<sup>36</sup> The IRS was a major contributor to the toolkit and helped to make this venture a success. We understand the IRS has also sought to improve its outreach to small business owners and practitioner groups and we encourage the IRS to ensure that taxpayers receiving SSA benefits are given ample coverage as well. To efficiently and effectively administer FPLP, the IRS must continue to improve its communication with taxpayers before it issues levies and before hardships occur.

### Summary

The National Taxpayer Advocate remains troubled that in spite of all of the specific recommendations in the 2006 Annual Report to Congress, the IRS is subjecting more and more taxpayers to the unnecessary financial and emotional harm that FPLP activities often bring. It is vital that the IRS conduct the necessary research and implement suitable controls and filters to ensure FPLP does not impact those who are already undergoing financial difficulties. Until such mechanisms are in place, the National Taxpayer Advocate firmly opposes any proposed expansion of the program to taxpayers likely to be harmed by such levies, and finds no basis for defraying the cost back to the taxpayer being levied. Thus, she recommends that the IRS postpone the expansion to RRB and other federal sources of individual income until IRS has completed its research and created an effective “low income and hardship” filter.

<sup>33</sup> Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2008 Revenue Proposals* 87 (Feb. 2007).

<sup>34</sup> *Id.*

<sup>35</sup> IRM 5.19.9.3.2.7(5) (July 14, 2005); CP 90/298, *Final Notice Before Levy on Social Security Benefits*.

<sup>36</sup> The Tax Toolkit is available at <http://www.tax-toolkit.com/>, 24 hours a day, seven days a week. It contains helpful information on a variety of subjects, including basic tax law, identify theft, and FPLP.

## IRS Comments

The Taxpayer Relief Act of 1997 authorizes the IRS to issue continuous levies on certain federal payments, including Social Security, Railroad Retirement, and each of the other federal payment streams referenced by the National Taxpayer Advocate. The IRS understands the sensitive nature of levying taxpayer assets and respects all taxpayer rights in using its levy power.

The IRS takes an enforcement action only after it makes multiple attempts to notify the taxpayer. FPLP levies are issued to the FMS only when all collection notices have been issued, the taxpayer's appeal rights period has passed, and the taxpayer has not contacted the IRS to resolve the account. Every notice sent to the taxpayer provides information on how to contact the IRS if he or she cannot pay the balance. We also advise taxpayers to submit information to substantiate their inability to pay, and analyze that information in determining whether a taxpayer is suffering a hardship.

The taxpayer may resolve the delinquent account at any time during the notice process and may stop or prevent the FPLP by contacting the IRS to resolve their delinquent account. Once the taxpayer contacts the IRS and presents documentation regarding a hardship, they are excluded from the FPLP program and the collection process. If the taxpayer is suffering an emergency hardship, a FPLP levy can be released expeditiously through the FPLP coordinator, as provided in current Internal Revenue Manual procedures.

### Current Status of FPLP Filter

The GAO determined that the IRS's previous filter that used Total Positive Income (TPI) to pre-screen FPLP levies on Social Security payments for hardship situations did not accurately reflect taxpayers' ability to pay. The IRS agreed with GAO and followed its recommendation to eliminate the filter and to rely on the additional final notice issued to Social Security beneficiaries that includes instructions on how to resolve the case. A subsequent IRS task force, including TAS representatives, was unable to design a valid replacement filter.

The IRS has always had processes and procedures in place to provide the proper relief as warranted for each and every taxpayer regardless of income level when a hardship is identified. Without a filter, however, the identification of hardship situations can only be correctly determined by an appropriate and up to date financial evaluation of each taxpayer's individual claim. Therefore, the IRS is currently working in partnership with TAS on a new research project. This effort focuses on determining if characteristics of taxpayers with Social Security benefits who are unable to pay their delinquent debt without incurring a financial hardship can be reliably used to systemically filter these taxpayers out of the FPLP process. The IRS has given this research its utmost priority and it will be completed in December 2007. Since non-income assets are not identified on tax returns, it has been a challenge to identify an indicator that can be used with a high degree of accuracy to predict

financial hardship. Using TPI matched with other characteristics the IRS retains may identify a more accurate filter than TPI alone. However, the reliability of such a filter will need to be determined by testing the final research model.

### IRS Interactions with the SSA

The IRS has worked with the SSA to improve the FPLP program in a number of ways. We helped SSA perfect its records to prevent duplicate levies by ensuring that the SSA honors only non-FPLP paper levies for taxpayers without an FPLP levy in process. We worked with SSA to identify Social Security benefits paid directly to a nursing home or other care facility and those payments are excluded from the FPLP process. We also met with SSA to determine if SSA had information that would identify low income taxpayers for potential exclusion from the FPLP. However, as noted in the National Taxpayer Advocate's report, SSA has no reliable indicators that can be used by the IRS in determining whether a taxpayer is low income or not.

### Levy Releases

The IRS agrees that it is critical that FPLP levies are released in a timely manner. We held a refresher training session in FY 2007 for the FPLP Coordinators, instructed them on the FPLP process and reminded the coordinators of the requirement to input a release code into the FMS database within 24 hours of receiving an emergency levy release request. Our focus in FY 2008 will be additional training for Automated Collection System (ACS) employees on the FPLP process to ensure employees are following the proper operational procedures, including the levy release process. In addition, the IRS is currently conducting a review of a sample of closed FPLP Operations Assistance Request (OAR) cases referred by TAS to determine causes of any levy release delays on hardship cases. The OAR cases we have reviewed to date do not reflect any such delays, nor have we found any specific examples where multiple FPLP levy payments were received after the taxpayer resolved his or her case.

### New FPLP Initiatives

The FPLP statute, § 6331(h)(2)(C) of the Internal Revenue Code, is the only statute specifically authorizing the levy of Railroad Retirement benefits. Prior to enactment of the FPLP statute, such benefits were exempt by law from levy (IRC § 6331(a)(6)). As a result, it is clear that the Congress intended for the IRS to add Railroad Retirement benefits to the automated FPLP program. To do so, the IRS must complete the necessary computer programming. We are on schedule to begin accepting levied Railroad Retirement benefit payments by January 2009.

The FPLP program was implemented to attach federal payments to taxpayers not meeting their tax obligations. As a result, the FPLP currently includes all federal employee salaries administered by the salary paying agencies of U.S. Department of Agriculture National Finance Center, Department of Interior's National Business Center, the United States



Postal Service, and the General Services Administration. The retirement benefits provided through the Office of Personnel Management are also currently included in FPLP. The IRS is in the process of including more federal employee salary payments not previously available to the program by adding the DFAS, which pays federal civil service employee salaries. We project an additional 344,500 levy payments for FY 2009 as a result of including these DFAS salaries in the FPLP.

The IRS understands any concern regarding the expansion of the payment streams included in the FPLP program and the potential impact on taxpayers with financial hardships. However, as noted above, the current FPLP process provides taxpayers multiple opportunities to contact the IRS, to identify their individual financial hardship situations, and to avoid or be removed from the FPLP levy program.

#### **FMS Fees Associated with Processing FPLP Levies**

The IRS reimburses FMS for actual costs incurred for performing services for FPLP. FMS is limited in what it can recover from the IRS to actual costs incurred as allowed under 31 U.S.C. § 1535, also known as the Economy Act. The FPLP was developed in order to interface with FMS's Treasury Offset Program as a systemic and efficient means for the IRS to collect delinquent taxes by levying federal payments disbursed or administered through FMS. The cost of the service provided by FMS has increased because the number and dollar amount of IRS delinquent accounts in the FPLP program has increased, as has the number of payment streams processed by FMS. In FY 2007, the IRS paid FMS \$20.4 million and the FPLP collected \$345 million from delinquent taxpayers the same year. We anticipate FMS support costs, as well as revenue collected, will continue to rise over the next few years as additional payment streams are added to this very effective program.

#### **IRS External Communications Regarding FPLP**

IRS.gov contains FPLP information, as does Publication 594, The IRS Collection Process, which is sent with the FPLP notice. The IRS is expanding communications to improve its ability to reach impacted taxpayers before a FPLP levy becomes effective. This strategy includes using existing partnerships with federal disbursing offices like DFAS. These disbursing offices, and other organizations like AARP, will distribute information directly to their customers regarding tax obligations for income received and the potential for IRS levy action when the proper steps are not taken. For example, DFAS has agreed to include such information in the leave and earning statements of its payees and the IRS is piloting a program aimed at military retirees that includes a promotional DVD that explains post-retirement federal tax obligations.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS understands the sensitive nature of levying taxpayer assets and that it respects all taxpayer rights in using its levy power. However, since this response is identical to the IRS response on the same issue in the 2006 Annual Report to Congress, it is questionable whether the IRS truly recognizes the unnecessary financial and emotional harm that FPLP activities often bring to taxpayers who may already face financial difficulties.<sup>37</sup> Although the IRS has a legal right to take such action, the program continues to create hardships for some of our most vulnerable taxpayers. This is illustrated by the fact that 86 percent of the FPLP levy payments received are associated with Social Security benefits which may in many cases represent a taxpayer's primary or sole source of income.<sup>38</sup>

The National Taxpayer Advocate acknowledges that the IRS has taken several positive steps toward improving its administration of FPLP over the past year and applauds these improvements. These efforts include the IRS's collaboration with the SSA to identify benefits paid directly to a nursing home or other care facility as well as the renewed emphasis the IRS has placed on FPLP levy release procedures. We applaud the IRS for nurturing and strengthening its relationships with external stakeholders, such as the SSA, and for improving the training of its personnel on FPLP issues. We have long advocated for such proactive measures, and the IRS's efforts should help to educate employees as well as external customers about the heightened sensitivity that surrounds FPLP.

### *Current Status of FPLP Filter*

Although GAO previously concluded the Total Positive Income filter was an "inaccurate indicator of a taxpayer's ability to pay," we continue to believe that having no filter at all is not the most feasible solution.<sup>39</sup> We applaud W&I for its agreement to collaborate with TAS to address this issue, and believe that it is a good opportunity for both sides to confer and consider the relevant issues. We fully understand the challenges surrounding such an undertaking, but remain concerned that a suitable FPLP filter to effectively screen out taxpayers who face the greatest risk of financial hardship has not yet been developed. Therefore, it is essential that this project is given the highest priority so an effective filter will soon be in place.

The National Taxpayer Advocate believes that a balanced approach to filter development must be adopted. An effective filter should not just ensure that taxpayers able to sustain a levy are included in the program, but should also ensure that taxpayers subjected to hardship by an FPLP levy are protected from the program. While an effective filter may

<sup>37</sup> See National Taxpayer Advocate 2006 Annual Report to Congress 124 (IRS response).

<sup>38</sup> IRS, Wage and Investment Division spreadsheet, *FPLP Monthly Counts FY2007*.

<sup>39</sup> General Accounting Office, GAO 03-356, *Tax Administration, Federal Payment Levy Program Measures Performance and Equity Can Be Improved* 11 (Mar. 6, 2003).

prevent some taxpayers who are able to endure the levy without hardship from being systematically levied, the IRS still has the option to research these accounts through its regular procedures and issue levies appropriately.

As stated in prior annual reports, the IRS policy of relying on the additional notice from the IRS to Social Security beneficiaries prior to the FPLP levies provides an inadequate safeguard for taxpayers in these situations.<sup>40</sup> These pre-levy notices are issued to the last known address, which is generally the address on the last return filed. However, since many of these taxpayers are no longer required to file, it is highly likely that they do not actually receive notices until the IRS has already levied upon their benefits. Thus, the current process does not ensure that a taxpayer has the ability to address a potential FPLP levy until *after* the taxpayer has been levied and an economic burden has been created.<sup>41</sup> This is further illustrated by the fact that nearly three out of every four taxpayers who come to TAS for assistance with an FPLP levy receive some type of relief from their hardship (*i.e.*, levy release or removal from the FPLP process).

### ***New FPLP Initiatives***

Despite all these concerns surrounding the program, the IRS has continued to push forward with expansion of FPLP to other federal payment sources commonly associated with a taxpayer's sole or primary source of income. While we agree that Congress enacted FPLP legislation to encourage tax compliance among individuals and businesses receiving federal payments, and that IRC § 6331(h)(2)(C) specifically authorizes the IRS to levy Railroad Retirement Benefits or other federal sources of income, we are troubled that the IRS is pursuing expansion when it has yet to fix the current problems with FPLP. However, we want to draw a distinction between retirement and wage income. The National Taxpayer Advocate is concerned about the most vulnerable taxpayers and thus reiterates that FPLP should not be expanded to any source of retirement payments, such as RRB and military income. We will continue to object to the addition of these payment sources until the IRS has completed its research and created an effective low income and hardship filter. With respect to salary-type payments, we are not averse to the IRS adding new sources to FPLP. However, the IRS should exercise caution when doing so. Moreover, once a screen has been successfully tested against Social Security benefits, we would encourage the IRS to expand such screen to accurately predict whether levies on taxpayers' wages would cause similar hardships.

### ***IRS External Communications Regarding FPLP***

We are very pleased to hear that the IRS is moving beyond the traditional publications that are included with required notices and is expanding communications to improve its ability

<sup>40</sup> We discussed problems with the IRS's use of the "last known address" in delivering the notice of intent to issue FPLP levies in the 2005 Annual Report to Congress, *Most Serious Problem: Levies on Social Security Payments*, as well as the 2006 Annual Report to Congress, *Most Serious Problem: Levies and Most Serious Problem: Collection Issues of Low Income Taxpayers*.

<sup>41</sup> Taxpayer Advocate Service, *Business Performance Management System* (Sept. 30, 2007).

to reach impacted taxpayers before a FPLP levy becomes effective. As TAS has historically filled the outreach void, we pledge to continue to partner with and assist the IRS on these important educational ventures. Moreover, we strongly encourage the IRS to explore additional ways of reaching taxpayers who receive Social Security benefits since these represent the majority of all FPLP levy payments received.

The National Taxpayer Advocate acknowledges the IRS has a legal right to attach federal payments of taxpayers not meeting their tax obligations, and that FPLP can be a very effective means of recouping these delinquent tax debts, but only when proper safeguards are in place to ensure that taxpayers with the greatest potential for hardship are identified and removed from the program before the IRS issues a levy. With 86 percent of all FPLP levy payments received in FY 2007 having been associated with Social Security benefits (and the rate continuing to increase annually since FY 2005), the time is now for the IRS to act with urgency to resolve this longstanding problem.

## Recommendations

The National Taxpayer Advocate recommends that the IRS:

- Finalize its current FPLP research study and move forward with the development and implementation of suitable controls and filters to systemically screen out taxpayers who depend on Social Security benefits for their health and welfare. Once the study is completed, the IRS should then determine if it could then extend these same controls and filters to accurately predict hardships for all other FPLP income sources and apply them accordingly.
- Postpone any plans to expand the FPLP to RRB and any other federal payments related to retirement income until a suitable “low income and hardship” filter has been created.
- Apply its “low income and hardship” filter, when available, to all FPLP payments commonly associated with a taxpayer’s primary or sole source of income, including salary-type payments. The screen should also be modified if necessary.
- Conduct additional research regarding how FPLP notices are issued. Rather than simply mailing them to the taxpayer’s last known address, the IRS should consider other options to ensure that notices of intent to levy on Social Security benefits via the FPLP program are mailed to the *best* address available. At a minimum, the IRS should utilize address research resources that are readily available via the Internet, and coordinate with SSA to determine if the IRS’s last known address for the taxpayer matches up with SSA records.
- Conduct outreach efforts that specifically target taxpayers receiving Social Security benefits or other federal pension or retirement income.
- Establish mandatory FPLP training for all public contact employees to better educate them about the intricacies of the entire FPLP process (pre- and post-levy) and deliver this training by the end of FY 2008.

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## Third Party Payers

### Responsible Official

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division

### Definition of Problem

In recent years, a number of third party payers have gone out of business or embezzled their customers' funds.<sup>1</sup> Because employers remain liable for payroll taxes, however, employers (especially self-employed and small business taxpayers) who fall victim to these situations can experience significant burden. This burden includes not only being forced to pay the amount twice – once to the third party payer that absconded with the funds and a second time to the IRS – but also being liable for interest and penalties. Some small businesses may not be able to recover from these financial setbacks and will be forced to cease operations.

These situations also impact effective tax administration. The IRS faces difficult decisions about how to handle these cases. The National Taxpayer Advocate has identified several aspects of IRS processes and procedures that contribute to or compound these difficulties, including:

- Lack of adequate information about the potential risks of using certain third party payers and absence of prompt notification of affected employers about third party payer failures;
- Limited IRS tracking of employer-third party payer relationship;
- Problems when third party payers change addresses of taxpayer clients to their own without the knowledge of the taxpayer/employer;
- Problems when third party payers cease business;
- Collection policies against clients of defunct third party payers;
- Inconsistent approach to third party payer business failures; and
- Inadequacy of early intervention programs.

<sup>1</sup> See SB/SE Fraud Digest, August 2007, available online at <http://SB/SE.web.irs.gov/compliance/TechDigest/FraudEdition/2007/2007-08/Payroll.htm>.

## Analysis of Problem

### Background

Employers are required by law to withhold and deposit employment and income taxes from wages paid to their employees.<sup>2</sup> Third party payers provide a valuable service to employers, especially small businesses, by helping them comply with a myriad of federal, state, and local employment tax requirements, which can be costly and burdensome to the employer. Third party payers play a significant role in tax administration by facilitating payroll tax processing and collection. In fiscal year (FY) 2007, nearly 20 percent of employers nationwide utilized third party payers to transmit approximately one third of all electronic federal tax deposit received by the Treasury.<sup>3</sup>

In over 60 years since the enactment of the IRC Subtitle C, *Employment Taxes*, the payroll industry has spawned various types of third party arrangements for reporting, filing, and payment of employment taxes. Table 1.22.1 illustrates the range of responsibilities, required forms and authorizations, potential tax liability of the third party payer and the client employer, and the current regulatory authority or absence thereof associated with the use of each type of third party payers.

<sup>2</sup> See generally IRC §§ 3101, 3102, 3111-3113, and 3121-3128 (Federal Insurance Contributions Act); IRC §§ 3201, 3202, 3211, 3221, 3231-3233 and 3241 (Railroad Retirement Tax Act); IRC §§ 3301-3311 (Federal Unemployment Tax Act); IRC §§ 3401-3407 (collection of income at source on wages); IRC §§ 3501-3511 (general provisions related to employment taxes); IRC § 6011 (general requirement of return, statement, or list); IRC § 6051 (receipt for employees); and IRC § 6302(g) (deposits of Social Security taxes).

<sup>3</sup> See IRS, *EFTPS Deposits Received and Processed, Volumes and Dollars Collected FY 2007 Year End* (Sept. 28, 2007). See also Brady Bennett, Director, Filing and Payment Compliance, Wage and Investment Division, *Talking Points, Important Contributions of Reporting Agents, SB/SE Focus and Updates*, National Reporting Agents Forum (Feb. 21, 2007), available online at <http://SB/SE.web.irs.gov/cl2/cl/speeches/default.asp?page=3&sort=dateTime%20DESC&whereClause>.

**TABLE 1.22.1, Third Party Arrangements**

Authority	Common Law Employer (CLE) <sup>4</sup>	Third Party Arrangements		
		Form 2678 Agent <sup>5</sup>	Form 8655 Reporting Agent (RA)	Payroll Service Provider (PSP)
Can file certain employment tax returns?	<b>Yes.</b> The CLE may file its own returns, using its own EIN.	<b>Yes.</b> The agent files an aggregate return for all CLE clients, using the <i>agent's</i> EIN. Agent can file those returns listed on Form 2678 appointment request.	<b>Yes.</b> The RA signs and is generally required to file electronically a separate return for each CLE client, using the <i>client's</i> EIN. The RA can e-file returns listed in Rev. Proc. 2007-38 and shown on the Form 8655 authorization request.	<b>Yes.</b> The PSP prepares a separate return for each client using the <i>client's</i> EIN. After CLE client signs the return, either the CLE client or the PSP may file the return on paper.
Can file Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return?	<b>Yes.</b> CLE files separate return using its own EIN.	<b>No,</b> in most cases. <sup>6</sup> clients must file FUTA tax returns using their own EINs.	<b>Yes.</b> RA signs and generally files electronically separate returns using client's EIN.	<b>Yes.</b> Client or PSP files separate returns using client's EIN.
Has employment tax liability?	<b>Yes.</b>	<b>Yes.</b> Client and agent are both liable for paying the client's employment taxes, filing returns, and making deposits and payments for the taxes reported.	<b>No.</b> Client, not RA, remains liable for ensuring all tax returns are filed timely and all deposits and payments are made timely.	<b>No.</b> Client, not the PSP, remains liable for ensuring all tax returns are filed timely and all deposits and payments are made timely.
Specific guidance in addition to Code, regulations and Circular E.		<b>Rev. Proc. 70-6;</b> <b>Notice 2003-70</b> (state and local governmental agents).	<b>Rev. Proc. 2007-38.</b>	

**Problems with IRS Processes and Procedures**

*Lack of Adequate Information About the Potential Risks of Using Certain Third Party Payers and Absence of Prompt Notification of Affected Employers About Third Party Payer Failures*

Current IRS forms and publications do not adequately inform employers about the potential risks of designating a third party responsible for reporting and payment of payroll taxes. The IRS also fails to advise taxpayers timely when a third party payer defaults on paying employment taxes. The National Taxpayer Advocate is concerned that taxpayers may be confused about the scope of authority conferred on the various types of third party payers and which forms are appropriate for the particular type of third party arrangement.

Because of the magnitude of the potential liability on a taxpayer that uses a third party payer that defaults, employers would benefit from educational outreach to employers, enhanced explanations, and cautions on the designation forms to ensure that employers understand the designations and the consequences of using a third party payer.

<sup>4</sup> A Professional Employer Organization (PEO), depending on the facts and circumstances, could fall within the CLE category or any of the third party arrangement categories. However, a PEO also may not fall within any of the categories.

<sup>5</sup> A transfer/paying agent can also receive authorization to report and deposit amounts withheld for payers by filing a Form 2678.

<sup>6</sup> Exceptions may apply for an agent where the employer is a disabled individual or other welfare recipient receiving in home care through a state or local program. See Most Serious Problem, *Employment Tax Treatment of Home Care Service Recipients, infra*.



The IRS should also create a publication that explains, in chart format, the differences between and responsibilities of the various third party payers. The publication should treat as a third party payer any person who provides payroll tax services if such person has the control, receipt, custody, or disposal of client funds for the purpose of making federal payroll tax deposits. Moreover, the IRS should create a separate form for designating a third party payroll agent that will allow it to effectively monitor compliance to prevent fraud. The IRS should also commit to more educational outreach to employers.

### *Limited IRS Tracking of Employer-Third Party Payer Relationship*

IRS systems cannot accurately identify the number of third party payers and the number of taxpayers who use these agents.<sup>7</sup> Prior to January 2007, the IRS did not record employer-agent relationships established under IRC § 3504.<sup>8</sup> Further, the IRS is unable to identify the specific employers included in the aggregate return filed by Form 2678 agents on behalf of multiple clients.<sup>9</sup> The IRS's inability to effectively monitor employers' third party authorizations and terminations results in significant compliance risks. The IRS should develop procedures to establish accurate links and cross-references between the third party payers and their clients' accounts. IRS systems should be able to identify a third party payer and list every employer associated with that third party payer.<sup>10</sup> Moreover, through outreach and education, the IRS should encourage employers to use third party payers that initiate Direct EFTPS deposits from employers' own bank accounts directly into the federal treasury, thereby minimizing the opportunity for fraud.

### *Problems When Third Party Payers Change Addresses of Taxpayer Clients to Their Own Without the Knowledge of the Employer*

Our review of a number of taxpayers' accounts revealed significant flaws in the IRS procedures for changing a taxpayer's address. Third party payers can change a taxpayer's address of record simply by filing a tax return. The IRS does not notify the taxpayer of the change, even in situations where the third party payer does not have the authority to initiate such a request. Consequently, when a third party payer fails to make a tax deposit on behalf of the employer, the IRS sends collection notices only to the third party payer, and the affected employers are unaware of the problem as taxes are assessed and interest and penalties accrue. Generally, a taxpayer becomes aware of the underpayment as a result of a levy, by which time a considerable tax liability has developed. In these situations, the IRS holds the taxpayer ultimately responsible for the payment of taxes, although the failure to

<sup>7</sup> See Small Business/Self-Employed division (SB/SE) response to TAS research request (Oct. 25, 2007).

<sup>8</sup> Generally, IRC § 3504 allows an employer to designate an agent to file returns and make deposits or payments of employment taxes. When an agent acts under IRC § 3504, both the employer and the agent are liable for the employment taxes. See IRC § 3504; Treas. Reg. § 31.3504.

<sup>9</sup> See SB/SE, *Employment Tax Strategy Template* (May 7, 2007).

<sup>10</sup> In FY 2007, the IRS team that redesigned Form 2678 also drafted an allocation schedule for agents operating under the provisions of IRC § 3504. The agent would file the schedule with the aggregate Form 941 listing each client's payroll and tax liability information. At the time of this report, the schedule described above is still in draft form.

notify the taxpayer of the change of address and ensuing delinquency contributed in part to the accumulation of the employment tax indebtedness.<sup>11</sup>

The IRS should monitor the practice of allowing third party payers to change the employer's address to the address of the third party payer. The IRS should establish a procedure to send duplicate notices to the employer and the third party payer. The IRS should notify affected employers when it becomes aware of a defunct third party payer. In cases where the third party payer files under its own EIN with multiple clients, the IRS should be able to track whether an employer is a client of a third party payer. This tracking system would facilitate the notification of the employer as well as the third party payer regarding arrearages, account adjustments, or outstanding balances.

### *Problems When Third Party Payers Cease Business*

When third party payers do not file the required employment tax returns or make the required deposits, employers remain liable for the underlying tax, interest, and penalties.<sup>12</sup> Unfortunately, an increasing number of third party payers have gone out of business, leading to a growing amount of uncollected tax liability. When third party payers fail or commit fraud and abscond with their customers' funds, leaving millions of dollars in employment taxes unpaid, their clients face significant economic difficulties. Usually, defunct third party payers do not have sufficient assets to collect against upon default. The IRS then has no recourse other than to initiate collection of unpaid employment taxes from the employers. Not only are employers forced to pay the amount of their employment tax liability twice (once to the failed third party payer and again to the IRS), but they may also be liable for interest and penalties. Moreover, in attempting to resolve the tax liability, many employers will also invest significant amounts of time and incur additional expense for representation before the IRS.

In one recent case, a third party payer allegedly misappropriated clients' tax funds instead of paying their federal and state employment tax liabilities.<sup>13</sup> The third party payer filed tax returns for clients using its own address and often paid the clients' liabilities using checks that were later returned by the financial institutions for insufficient funds. The third party payer commingled the clients' funds and often used one client's funds to pay another's liabilities.

<sup>11</sup> In August 2006, the Bankruptcy Court, in *In re: Firstpay, Inc.*, No. 03-30102, 2006 Bankr. LEXIS 2339 (2006), recognized that the IRS bears a significant responsibility for allowing the embezzlement to continue. The judge inquired: "How is it that no individual in the employ of the IRS was aware of the Debtor's fraudulent scheme, when as the court was told during the course of a hearing, literally pallets loaded with deficiency notices were delivered daily to one address?" (The court meant notices and demands for payment, as employment taxes are not subject to the deficiency procedures.)

<sup>12</sup> See Table 1.22.1, *Third Party Arrangements*, *supra*.

<sup>13</sup> See Adam Sichko, *Owner of Ballston Spa Payroll Company Pleads Guilty to Larceny*, Bus. Rev. (Albany) (Nov. 2, 2007), available online at <http://www.bizjournals.com/albany/stories/2007/10/29/daily45.html>. The article described an instance of an embezzlement scam, in which the defunct payroll service company failed to pay over employment taxes on behalf of client employers to federal and state authorities. According to the authorities, the owner of the payroll service provider kept her clients in the dark for more than a year partly by filing change of address forms with the IRS, so that the payroll service provider, not the client employers, received IRS notices and demands for payment. One business owner commented, "She was making all the weekly payments, keeping things up to date. It seems as if it took 19 to 20 months to destroy what took 14 years to create...." According to the author, the payroll service provider pled guilty to one count of grand larceny and is scheduled to be sentenced in January 2008.

In 2006, four third party payers failed to remit millions of dollars in payroll taxes and failed to file quarterly employment tax returns for thousands of taxpayers across the country.<sup>14</sup> The third party payers commingled and improperly used funds that were held in trust for their clients' payroll tax deposits, thus rendering over 800 of their clients' accounts unpaid.<sup>15</sup>

### Collection Policies Involving Clients of Defunct Third Party Payers

#### *IRS Current Collection Policy Approach*

By analyzing recent cases involving defunct third party payers, the National Taxpayer Advocate has identified employment tax collection policies that unnecessarily add to taxpayer burden. These policies fail to adequately address situations when a third party payer defaults on its obligations to report and remit payroll taxes on behalf of the employer and the employer is then subject to assessment and collection of the delinquent employment taxes. In addition, other than penalty relief, the IRS does not address how and whether these taxpayers qualify for collection alternatives.<sup>16</sup> The IRS issued interim guidance providing for penalty relief in specific instances of third party payer failures<sup>17</sup> and separately addressed the use of "effective tax administration" (ETA) authority to compromise on the basis of equity and public policy.<sup>18</sup> However, the interim guidance regarding the use of the ETA authority should do more to encourage IRS personnel to compromise tax liability in these situations. Moreover, where the IRS's own procedures exacerbated third party payer-related delinquencies, this fact should weigh heavily in favor of entering into offer in compromise agreements with affected taxpayers.

#### *Inconsistent Approach to Third Party Payer Business Failures*

The IRS collection strategy for employer payroll tax delinquencies resulting from third party payer business failures has been inconsistent. In some instances, the IRS has taken a coordinated approach – communicating with all affected employers, staying certain collection actions such as liens and levies for all affected employers, and waiving penalties in

<sup>14</sup> See Memorandum from Director, Collection Policy, to Collection Area Directors, *Penalty Relief* (Sept. 21, 2006); ALERT: *One Time Penalty Abatement Procedures for Clients of Payroll Service Provider*, Ref. No. BMF 07464 (Oct. 26, 2007).

<sup>15</sup> See Memorandum from Director, Collection Policy, to Collection Area Directors, *Penalty Relief* (Sept. 21, 2006); see also Carrie Mason-Draffen, *Payroll Firm Fails to Pay Taxes*, *Newsday*, July 27, 2006, at A46; Carrie Mason-Draffen, *Payroll Firm's Founder Charged*, *Newsday*, Oct. 12, 2007, at A44; and Saeed Ahmed, *Canton Man Gets Jail for Defrauding Clients*, *Atlanta Journal-Constitution*, June 28, 2007, at D8.

<sup>16</sup> In 1998, Congress clarified that the IRS could also accept an offer-in-compromise based on ETA, which the IRS interprets as allowing it to compromise on the basis of "economic hardship" or "equity and/or public policy" (called "non-hardship" ETA offers). See IRS Restructuring and Reform Act of 1998, Pub. L., No. 105-206 (1998); H.R. Conf. Rep. 599, 105<sup>th</sup> Cong., 2d Sess., 289 (1998); IRC § 7122(d)(1); Treas. Reg. § 301.7122-1(b)(3); see also Most Serious Problem, *Inadequate Training and Communication Regarding Effective Tax Administration Offers*, *infra*.

<sup>17</sup> Memorandum from Director, Collection Policy to Collection Area Directors, *Penalty Relief* (Sept. 21, 2006); ALERT: *One Time Penalty Abatement Procedures for Clients of Payroll Service Provider*, Ref. No. BMF 07464 (Oct. 26, 2007).

<sup>18</sup> Memorandum for Directors, Collection Area Offices, from Director, Collection Policy, Control No. SB/SE-05-1107-058, *Reissuance of Guidance Regarding "Non-hardship" Effective Tax Administration Offers in Compromise* (Nov. 15, 2007) (generally limiting the focus of IRS personnel to abatement of interest and penalties).

appropriate cases.<sup>19</sup> In other instances, the IRS has taken a case-by-case approach, reacting to the employers' inquiries as they learned of the arrearages. In some cases, the IRS has refused to abate penalties unless the affected taxpayer filed a police report.<sup>20</sup>

The National Taxpayer Advocate is concerned that there is no coordinated or centralized approach to identifying and assisting all affected taxpayers. The IRS has not effectively attempted to identify all of the affected taxpayers and make all alternative options, including ETA offers in compromise, available to these taxpayers consistently throughout the country. The National Taxpayer Advocate believes the IRS should establish a comprehensive and consistent approach.

Initially, the IRS should group such payroll agent cases into buckets on the basis of the common set of facts that apply to each affected client of the particular third party payer. For example, one group of taxpayers may share the common fact that the third party payer embezzled the funds and the IRS failed to notify the taxpayers because of an ongoing criminal investigation against the third party payer. At this stage of the process, the National Taxpayer Advocate recommends that the IRS temporarily suspend collection action against the affected clients to provide them a sufficient opportunity to explore payment alternatives. Once a particular third party payer is placed in a bucket with a common set of facts, the IRS may then determine a basic remedy or general relief applicable to that particular bucket, based on the general ETA principles of equity and public policy that might involve a combination of penalty, interest or tax abatement. Further, with the established basic remedy as a starting point for relief for all affected clients, the IRS would next examine all facts and circumstances pertinent to a particular third party payer's clients and determine whether more or less relief than a basic remedy is warranted in each specific case. Such a facts and circumstances analysis applied on a case-by-case basis will ultimately produce fair and equitable results for the taxpayers and improve confidence in the tax system, especially in cases where the IRS's inaction or slow response contributed to the escalating delinquencies. Significantly, a taxpayer who has done his or her best to comply with its tax obligations should not be treated the same way as an intentionally noncompliant taxpayer.

### *Early Intervention*

The IRS has various programs that address taxpayer delinquencies. One program is the Federal Tax Deposit (FTD) Alert program, which identifies taxpayers that appear to be delinquent in making deposits of withholding taxes before their quarterly employment tax returns are due to be filed. Revenue officers will then visit the taxpayer to discuss FTD requirements and secure payment of taxes. Although the program helps taxpayers comply

<sup>19</sup> Memorandum from Acting Director, Field Operations to Area Directors, Compliance Field Operations, Deputy Director, Compliance Services, and National Taxpayer Advocate (June 12, 2003).

<sup>20</sup> Systemic Advocacy Management System (SAMS) Project; National Taxpayer Advocate FY 2008 Objectives Report to Congress.

with their obligations, the Treasury Inspector General for Tax Administration (TIGTA) has noted the alerts can be worked more effectively.<sup>21</sup>

The IRS also uses an early intervention report to address employment tax delinquencies. The report allows the IRS to intervene and work with taxpayers and third party payers to resolve tax arrearages and prevent future delinquencies.<sup>22</sup> However, the report may be inaccurate with respect to third party payers, making it an ineffective collection tool for these cases.<sup>23</sup>

We commend the IRS for its current efforts to identify these taxpayers and address tax delinquencies. These preventive actions serve the taxpayers' interest by helping them to avoid unnecessary enforcement action. However, we encourage the IRS to improve and expand the early intervention report and to implement the recommendations offered by TIGTA to make the FTD Alert program more effective.<sup>24</sup> The IRS should implement procedures allowing early interventions when a third party payer is delinquent in satisfying employment tax liabilities on one or more client accounts for more than one month.

### IRS Comments

The IRS agrees that serious problems are associated with the collection of employment taxes in cases where an employer engaged a third party to handle the employer's employment tax responsibilities and the third party failed to fulfill its obligation. While the IRS does play an important role in addressing the results of the problem, the employer is not removed from their employment tax obligations when entrusting intermediaries with the deposit and payment of their federal tax liabilities. In the case of fraud, although a third party payer may concede misappropriation of funds on behalf of their client, this still does not relieve the taxpayer of their tax obligations. Employers using third party payroll providers should use due diligence in the selection of a third party payer with regard to the compliance associated with their tax obligations.

The IRS disagrees with the statement that employers are being forced to effectively pay their employment taxes twice. As a technical matter, this statement incorrectly characterizes and reinforces the misconception that taxpayers are paying taxes twice to the IRS. The IRS has the responsibility for administering the tax laws fairly and equitably among the taxpaying public. When the third party fails to pay the taxes on the employer's behalf, the

<sup>21</sup> Treasury Inspector General for Tax Administration, Ref. No. 2007-30-180, *The Federal Tax Deposit Alert Program Helps Taxpayers Comply with Paying Taxes, but Alerts Can Be Worked More Effectively* (Sept. 17, 2007).

<sup>22</sup> SB/SE response to TAS research request (Oct. 25, 2007).

<sup>23</sup> The early intervention report includes tax liabilities for taxpayers who use reporting agents. However, not all third party payers are required to file Form 8655, *Reporting Agent Authorization*. Moreover, the IRS cannot readily determine if the delinquencies are a result of third party payer misappropriation or the taxpayer's failure to comply. SB/SE response to TAS Research Request (Oct. 25, 2007).

<sup>24</sup> Treasury Inspector General for Tax Administration, Ref. No. 2007-30-180, *The Federal Tax Deposit Alert Program Helps Taxpayers Comply with Paying Taxes, but Alerts Can Be Worked More Effectively* (Sept. 17, 2007). TIGTA recommended the IRS measure taxpayer compliance after contact on an FTD alert, update IRS guidance, and emphasize procedures and documentation when working an FTD alert. The IRS agreed with the recommendations.

IRC authorizes the IRS to collect the employment taxes from the employer. Although the employer paid funds to the third party payer, credit for the deposit is not given until it is received by the IRS. Upon collection of the tax, the IRS has only received the payment one time. It would not be fair or just to the employers who paid their employment taxes to the federal government to absolve another employer of their liability due to these unfortunate business decisions. Allowing taxpayers' credit for employment taxes that were not received from their third party payroll providers would make the federal government the ultimate insurer and victim of a transaction to which it was not a party.

### **Absence of adequate information about the potential risks of using third party payers**

Each third party payer fulfills a different role for an employer and follows different processes. There are different procedures for each type of third party payer designation because each third party payer is fundamentally different. Authorizations, responsibilities, and liabilities for employment taxes may be different depending on the specific type of third party payer, and the four types of third party payroll payers cannot realistically be lumped together into one definition or a one size fits all approach.

The IRS is working to educate taxpayers to ensure that they have a better understanding of each type of third party payer and associated risks. Each type of authorization or designation form clearly addresses the specific authorization being given to the third party payer and the consequences in the event of default. The IRS also provides a chart on its website ([www.irs.gov](http://www.irs.gov)) entitled "*Third Party Authorizations*", which includes explanations and illustrations for two of the different types of payers, their responsibilities, and authority.<sup>25</sup> Form 2678, Employer/Payer Appointment of Agent, has not yet been included in this chart, but the IRS does plan to add this to the document.

#### Limited IRS Tracking of Employer-Third Party Payer Relationship

The IRS has taken several actions to improve the tracking of businesses using various third party payers. Currently, the IRS uses Form 2678, to record the employers of § 3504 agents filing on behalf of employers and receives approximately 30,000 of these forms per year.<sup>26</sup> In 2005, the SB/SE Office of Taxpayer Burden convened a task force to study the use of Form 2678. The task force concluded that the form was not being used to its full potential and made the following changes:

- Designated specific action codes to show receipt of Form 2678 by the IRS and identify the relationship between the parties (*i.e.*, establishment of an authorization or termination).<sup>27</sup> This was implemented January 1, 2007.

<sup>25</sup> See Publication 4019, *Third Party Authorization, Levels of Authority*.

<sup>26</sup> Treasury Inspector General for Tax Administration, Ref. No. 2007-30-169, *Improvements Have Been Made to Monitor Employers That Use Professional Employer Organizations, but More Can Be Done* (Sept. 19, 2007).

<sup>27</sup> Action codes are used to designate an action to be taken on a taxpayer account.

- Redesigned the Form 2678 using a “plain language” format for simplicity and clarity. The new Form 2678 requires both parties to sign and was implemented May of 2007.
- Developed a schedule to attach to the Employer’s Quarterly Federal Tax Returns (Form 941) filed by each § 3504 agent that has been authorized to file on behalf of an employer. The schedule would list every employer for which the agent included on every aggregate Form 941 filed. This has not yet been implemented but is being studied for feasibility.
- Implemented a change to the computer system to prevent Employer’s Annual Federal Unemployment (FUTA) Tax Returns filed on an individual basis from “opening” an erroneous Form 941 filing requirement for when the Form 941 is filed in aggregate by the agent. This change prevents each client from receiving an erroneous Form 941 Tax Delinquency Investigation notice. The 941 filing requirement is satisfied by the organization’s filing of an aggregate Form 941 for all its clients. These corrective actions have been an important step in improving internal controls and reducing taxpayer burden.

The IRS has redesigned the Form 2678 twice since the task force convened, with the latest version published in October 2007 to add clarity for the filer. In addition to the above recommendations, the IRS will continue to explore options, including use of the revised Form 2678 or other similar form, to establish accurate links between Professional Employer Organizations and their clients.

The IRS acknowledges that the lack of effective monitoring of employer third party authorizations and terminations can result in increased taxpayer burden and cause significant compliance risks. We also acknowledge the need to enhance our computer systems to identify third party payroll payers and their client taxpayers, and are in the process of making several improvements in these areas.

- The Reporting Agents File (RAF) tracking system was recently enhanced and now has the capacity to differentiate between active and inactive agents. The system contains 6,481 reporting agents; indicating 5,622 as active and 859 as inactive.<sup>28</sup> This same system also has the ability to generate listings of employers associated with a specific Reporting Agent.
- SB/SE Collection is in the process of enhancing the Early Warning Report to establish accurate links and cross references between reporting agents and the clients with outstanding accounts that have Form 8655, Reporting Agent Authorization, on file.

The IRS continues to work through outreach and education to encourage employers to use reputable third party payers enrolled in and using EFTPS. The IRS also encourages employers using third party payers to verify and confirm timely deposits by utilizing EFTPS.<sup>29</sup>

<sup>28</sup> Information provided by RAF Project Leader, CAF/RAF Section in Detroit, MI.

<sup>29</sup> IRS, *Outsourcing Payroll Duties Can Be a Sound Business Practice, but ... Know Your Tax Responsibilities as an Employer*, at <http://www.irs.gov/businesses/small/article/0,,id=152975,00.html>



However, if the employer is unable to sign up for EFTPS, the same information is available to the employer by calling the toll-free number. IRS plans to develop and publicize articles regarding the benefits and convenience of using EFTPS. The IRS provides many EFTPS circulars and publications to the public. Publication 966, *Electronic Choices to Pay All Your Federal Taxes*, specifically provides employers with instructions on how to use EFTPS direct, which allows the electronic transfer of funds to the Treasury's account through the employers account.<sup>30</sup>

### Problems When Third Party Payers Change Addresses of Taxpayers Clients to Their Own

The IRS acknowledges there are systemic problems resulting in the third party payers' ability to change the employer's address to their own without notifying the client/employer. If a return is filed using a new address, then frequently that address will become the address of record. IRS Submission Processing procedures do require that *if it can be determined* by the tax return that it was completed by a third party payer, a Form 8822, *Change of Address*, must be signed by the taxpayer and submitted to the IRS prior to the address being changed. Otherwise, Form 2848, *Power of Attorney and Declaration of Representative*, must be signed by the taxpayer to give the authority to a third party payer to change the address. In January 2007, Submission Processing employees received refresher training on address change procedures. We agree that notifying the employer regarding address changes and collection notices would be beneficial to reducing the burden of taxpayers who find themselves in these types of situations. Further research is being conducted to determine the feasibility of implementing duplicate collection and change of address notices to all business taxpayers that use a third party payer.

### Problem When Third Party Payers Cease as Going Concerns

The IRS acknowledges that the lack of effective monitoring of employer third party authorizations and terminations can result in increased taxpayer burden. As discussed above, the IRS has taken several actions to improve the tracking of businesses using various third party payers and additional efforts are underway.

Several issues arise when third party payers cease operating. The IRS acknowledges that the failure of the third party payers to make deposits or their participation in fraudulent practices adversely affects many small businesses. The IRS continues to work to educate employers on the type of questions to ask when hiring a third party payer and to ensure the third party payer uses EFTPS. The IRS also ensures the third party payer authorization forms include statements indicating that signing the agreement does not relieve the taxpayer of the responsibility to ensure that all tax returns are filed and that all deposits and payments are made.<sup>31</sup>

<sup>30</sup> See Pub. 966, *Electronic Choices for Paying ALL Your Federal Taxes*, available at <http://www.irs.gov/pub/irs-pdf/p966.pdf>.

<sup>31</sup> See Form 8655, *Reporting Agent Authorization*, and Form 2678, *Employer/Payer Appointment of Agent*.

### Collection Policies against Clients of Defunct Third Party Payers

The National Taxpayer Advocate indicates that the IRS has done little to educate the public about the availability of ETA offers in compromise and that taxpayers affected by third party payers need to know that an ETA OIC is a collection alternative that may be available to resolve their liability. Taxpayers unable to pay their liabilities in full are potential candidates for a Doubt as to Collectibility (DATC) OIC. If a taxpayer does not qualify for a DATC offer, then an ETA offer in compromise may be an avenue for resolution. We agree that the ETA offer in compromise is a viable collection alternative for those taxpayers that meet the established ETA criteria.

The IRS maintains a strong commitment to educate the public and practitioners about ETA offers. We have incorporated information about ETA offers during our Tax Phone Forums and external OIC stakeholder presentations. In February 2007, the language in Form 656, Offer in Compromise, was revised to help clarify the definition of an ETA offer, identify when an ETA offer is appropriate and provided an outline of the documentation a taxpayer should include with an ETA offer. Information on ETA offers is also available in the Offer in Compromise section of the IRS website ([www.irs.gov](http://www.irs.gov)).

Internally, we have provided training on ETA offers to all Campus and Collection OIC program employees. In November 2006, we issued an interim guidance memorandum titled “Guidance Regarding “Non-hardship” Effective Tax Administration Offers in Compromise” to all Collection, Campus Compliance, and Counsel and Appeals employees. The memorandum provided detailed guidance on the criteria for a non-economic hardship OIC. The memorandum also provided specific examples of compelling public policy or equity determinations including liabilities incurred as a result of a criminal or fraudulent act of a third party, and IRS action or inaction causing unreasonable delay.<sup>32</sup> The guidance in the memorandum was included in training material provided to all offer specialists and Centralized Offer in Compromise (COIC) employees. In December 2006, these procedures are incorporated into the most recent revision of IRM 5.8, Offer in Compromise, which is currently in the clearance process.

We have taken active steps to educate the public, practitioners and Service employees about ETA offers, and will continue to evaluate our efforts and provide information to each on an ongoing basis. We agree that in order to maximize the effectiveness of this authority, their existence and parameters must be communicated to both taxpayers and IRS employees—and our efforts should aid and facilitate both in understanding when an ETA offer would be the appropriate remedy.

<sup>32</sup> Memorandum from Director, Collection Policy to Collection Area Directors, *Re-Issuance of Guidance Regarding “Non Hardship” Effective Tax Administration Offer in Compromise* (Nov. 2007) at <http://sbse.web.irs.gov/MS/IGMemos/file.asp?kf=583>.

### **Inconsistent Approach to Third Party Payer Business Failures**

Third party payer situations are addressed based on the unique facts and circumstances of the case involved. Each Collection Field Area has a designated central point of contact to ensure consistent treatment of cases with similar circumstances. The IRS is also exploring ways to work in concert with internal and external stakeholders to achieve the most effective resolution. In a recent case, Collection worked with TIGTA to obtain the list of clients impacted by a third party payer that absconded with funds allocated for employment taxes. The IRS created and sent a letter to all the clients of the third party payer providing specific contact information to expedite the resolution to their outstanding liabilities. This approach provided collection with the opportunity to notify and address each client of the third party payer as well as work the cases in a consistent manner.

While a coordinated approach would be preferred, it is not an available remedy for all situations based on the distinctions of each case and the nature of the third party payer role. This approach has worked favorably in some instances and the IRS will continue to explore the use of a coordinated approach where situations warrant.

### **Inadequacy of Early Intervention Programs**

The IRS appreciates the National Taxpayer Advocate's acknowledgement of our efforts to timely address tax delinquencies through the alerts process and early intervention reports. We are working to enhance the Early Warning Report to provide information that is more accurate and reliable in clearly and promptly identifying employers who have outstanding balances. We are consistently exploring available avenues to monitor Federal Tax Deposits (FTDs) of previously compliant taxpayers.

The IRS urges employers to exercise due diligence in selecting a third party payer that is reputable and uses EFTPS. Employers who use third party payers should use due diligence and take steps to verify deposits and filings are made on their behalf each quarter.

The IRS has also worked closely with the Department of Justice, TIGTA, and the Criminal Investigation Division to publicize unscrupulous providers and the actions taken to address criminal behavior in hopes that it would deter other third party payers from engaging in fraudulent behavior.

In summary, the IRS appreciates the National Taxpayer Advocate's attention to this area of compliance risk, and is committed to improving its policies and procedures with all third party payers who are entrusted by employers to file and pay on their behalf. While the ultimate responsibility remains with the employer to use due diligence in handling employment tax obligations, the IRS will continue its efforts to focus on educating taxpayers, encouraging the use of EFTPS, improving business systems, and developing early intervention tools in hopes of decreasing and/or minimizing the burden and financial impact to the taxpayer.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS is taking steps to address taxpayer concerns regarding third party payers, looking internally to address systemic failures as well as seeking to expand and clarify messages to the public regarding the wide range of options available to taxpayers. However, the National Taxpayer Advocate remains concerned by the IRS's limited plans to address compliance concerns of taxpayers who have been harmed due to a lack of comprehensive public guidance or limited internal controls, or find themselves the victims of a defunct or criminal payroll provider.

The National Taxpayer Advocate is also concerned by the IRS's failure to acknowledge that, from the taxpayer's point of view, the law requires a taxpayer who is a victim of third party payer failure to pay the amount of tax twice. From a taxpayer-centric perspective, it matters little if the payment goes to the IRS or the third party payer. What matters is the financial impact on the taxpayer is at least twice what is legally owed. The IRS will not be able to significantly improve its performance in this area until it acknowledges this perspective.

### *Absence of Adequate Information About the Potential Risks of Using Third Party Payers*

The IRS clearly recognizes an employer may be confused about the authority, responsibility and liability conferred on various third party payers and which forms are appropriate for the particular type of third party arrangement. The National Taxpayer Advocate suggests that taxpayers would benefit from educational outreach, enhanced explanations, and cautionary language on tax forms and publications.

The IRS's existing educational materials can be improved. For example, the Third Party Authorizations chart on the IRS website does not describe the reporting agent's responsibility and/or liability. The National Taxpayer Advocate suggests the IRS develop a brochure that explains, in chart format, the differences between the various third party payers and the responsibility and liability each assumes. The brochure should treat a third party as any person who provides payroll tax services if such person has the "control, receipt, custody, or disposal of" client funds for the purpose of making federal payroll tax deposits. The IRS should also create a talking point series for use at stakeholder meetings, conferences, and tax forums.

Currently, the IRS is able to monitor the accounts of employers and third party payers who file Forms 2678 and 8655 but not all third party payers file these forms. The IRS should create a separate form for designating a third party payer that will allow it to effectively monitor compliance to prevent fraud.

***Limited IRS Tracking of Employer-Third Party Payer Relationship***

The National Taxpayer Advocate is pleased the IRS has taken a series of corrective actions to improve identification of employer-third party payer relationships. These actions are an important step towards minimizing compliance risks and reducing taxpayer burden. However, we remain concerned about the following aspects of third party payer-employer relationships:

- The IRS cannot identify existing employer-relationships established prior to January 1, 2007.<sup>33</sup>
- The IRS has not yet implemented a schedule to be used by agents operating under IRC § 3504 to list every employer, for which the agent was designated, on every aggregate Form 941 filed.
- The IRS implemented a programming change to prevent taxpayers from receiving erroneous Form 941 tax delinquency notices. However, this change applies only to taxpayers and agents who filed Form 2678 after January 1, 2007. Taxpayers and agents could still be subject to inappropriate collection activity for prior years.

The National Taxpayer Advocate is pleased that the IRS recognizes that the lack of effective monitoring of employer-third party authorizations and terminations results in taxpayer burden and causes significant compliance risks.

The National Taxpayer Advocate supports the use of EFTPS by employers and third party payers. EFTPS offers businesses a convenient and secure way to pay taxes and enables employers, even those that use a third party payer, to verify tax payments.

The National Taxpayer Advocate applauds the IRS efforts to encourage employers to use EFTPS and to recommend reputable third party payers that use EFTPS. The IRS states that it plans to develop and publicize articles regarding the benefits and convenience of using EFTPS. Such articles should definitely include information about third party payer arrangements to help taxpayers avoid making unfortunate business decisions.

***Problems When Third Party Payers Change Addresses of Taxpayer Clients to Their Own***

We welcome the IRS's acknowledgment of significant systemic problems in the processing of third party payers' requested changes of address from the client address to their own without clear authorization by the client or notification to the client. This is a significant step toward addressing this concern. The National Taxpayer Advocate supports the IRS's initiative to utilize the refresher course. The IRS should consider including this topic as part of the Annual Filing Season Readiness training. The National Taxpayer Advocate looks forward to working with the IRS as it pursues further research to determine the feasibility of implementing duplicate collection and change of address notices to all business taxpayers that use a third party payer.

<sup>33</sup> See Most Serious Problem, *Employment Tax Treatment of Home Care Service Recipients*, *infra*.

### *Problems When Third Party Payers Cease Business*

The National Taxpayer Advocate encourages the IRS to continue to examine its internal processes regarding third party payer tracking and monitoring, and is prepared to work with the IRS to develop changes to reduce taxpayer burden. These concerns, as well as those created when third party payers fail, require a comprehensive approach that includes taxpayer outreach and education, internal procedural guidance to encourage the use of collection alternatives where appropriate, early detection of delinquent accounts, and notification to all affected stakeholders.

### *IRS Current Collection Policy Approach*

The National Taxpayer Advocate is pleased that the IRS is committed to educating the public and practitioners about ETA offers. The IRS suggests it has made significant efforts to communicate with stakeholders about these offers, but in response to TAS's formal request for the IRS to identify "all external communications related to ETA offers" in FY 2006 and FY 2007, the IRS did not produce any external communications on the subject. TAS's research of the published IRM and IRS training modules turned up only a few vague references to ETA offers, outside of the IRM and training modules for offer specialists.<sup>34</sup>

The IRS agrees that the ETA offer in compromise is a viable collection alternative for those taxpayers that meet the established ETA criteria. In cases of misappropriation of funds or embezzlement by a third party payer, the victimized taxpayers need to know all of the viable options that will allow them to continue their business operations despite the loss. In response to specific instances of third party payer failures, the IRS has issued guidance providing for penalty relief. IRS guidance regarding the use of the ETA authority should encourage employees to compromise tax liability in these situations, and not limit their focus to the abatement of interest and penalties.

To maximize the effectiveness of the OIC program, the IRS should provide specific direction and guidance to both its employees and external stakeholders, and continually assess the performance of OIC program results as they relate to ETA offers. TAS is more than willing to assist the IRS in developing training and other materials for stakeholders and employees on this important collection alternative.

### *Inconsistent Approach to Third Party Payer Business Failures*

The National Taxpayer Advocate continues to encourage the IRS to proactively pursue all of its administrative authority to develop a consistent approach to taxpayers impacted by third party payer business failures. These actions should include assuming the responsibility to notify affected taxpayers when the IRS becomes aware of a defunct third party payer, establishing uniform guidance for using ETA offers in compromise to relieve affected employers, suspending collection actions of the accounts of affected employers to provide

<sup>34</sup> For an in-depth discussion of our concerns, see Most Serious Problem, *Inadequate Training and Communication Regarding Effective Tax Administration Offers*, *infra*.

them a sufficient opportunity to explore payment alternatives, and developing pattern solutions (by grouping cases into “buckets” or categories) for situations where large numbers of taxpayers share common facts, to ensure a common starting point for relief, regardless of where the case is worked in the IRS.<sup>35</sup>

### *Early Intervention*

The National Taxpayer Advocate firmly believes that timely and personal interventions on collection accounts are powerful motivations for taxpayers to resolve tax problems.<sup>36</sup> She applauds the IRS’s efforts to enhance early intervention programs and to ensure the information is accurate, reliable, and timely to identify employers who have outstanding balances. The information gleaned from these reports and programs must allow the IRS to intervene and help taxpayers avoid huge tax debts, and identify non-compliant behavior by employers and their agents. The National Taxpayer Advocate also encourages the IRS to implement the recommendations offered by TIGTA in regards to making the FTD Alert program more effective. TAS is ready to work with the IRS to ensure that its systems can accurately identify and promptly notify affected clients of defunct third party payers of account arrearages as well as preventing unauthorized changes of clients’ addresses to those of third party payers.

## Recommendations

The National Taxpayer Advocate raises concerns about misappropriation of employment taxes by third party payers and urges the IRS to assume a greater role in protecting the taxpayers’ interests and assisting taxpayers in third party payer cases, including:

- Defining a third party payer and separately defining every category of payroll agents and subagents;
- Creating a separate form for designating a third party payer that covers all types of employment tax agents and providing enhanced disclosures about the consequences of using a third party payer;
- Developing additional communication products in a brochure format, including sufficient disclosures about the potential risks of using a third party payer on appropriate employment tax forms authorizing the use of a third party payer;
- Discontinuing the practice of changing the employer’s address to that of the third party payer unless there is clear authorization from the employer;

<sup>35</sup> Under the “bucket” approach suggested by the National Taxpayer Advocate the IRS would establish general relief based on a facts shared by a group of cases, with additional or less relief depending on a specific case’s facts, regardless of where the case (in which area) is worked.

<sup>36</sup> 2006 National Taxpayer Advocate Report to Congress 63, Most Serious Problem: *Early Intervention in IRS Collection Cases*. The National Taxpayer Advocate recommended IRS expand the practice in employment tax cases of making prompt face-to-face contact as early in the collection delinquency cycle as possible. This contact will ensure the maximum collection of revenue, prevent future delinquencies, and engage business taxpayers at a point when they have the best opportunity to resolve their tax problems while salvaging their businesses.



- Providing annual refresher training for Submission Processing employees;
- Issuing a notice to taxpayers when making address changes;
- Issuing duplicate collection notices to affected employers and the third party payer;
- Assuming the responsibility to notify affected taxpayers when the IRS becomes aware of a defunct third party payer;
- Establishing procedures for prompt identification and notification of affected employers in cases involving third party payer failures;
- Establishing uniform guidance for using effective tax administration offers in compromise to relieve affected employers – victims of third party payer failures;
- Temporarily suspending collection of the accounts of affected employers to provide them a sufficient opportunity to explore payment alternatives; and
- Developing “global” remedies for situations where large numbers of taxpayers share common facts, to ensure a common starting point for relief, regardless of where the case is worked in the IRS.

MSP  
#23**Employment Tax Treatment of Home Care Service Recipients****Responsible Official**

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division

**Definition of Problem**

Many elderly and disabled individuals receive in-home care and support services administered through a variety of state and local government health and welfare programs.<sup>1</sup> Under certain circumstances, these programs are funded by federal, state, or local governments.<sup>2</sup> The precise arrangements under which the services are performed vary from state to state. In consumer-directed programs, the elderly and disabled individuals or their representatives use government funds to obtain in-home assistance and control the home care services they receive.<sup>3</sup> These services are performed by home care service workers (HCSW).<sup>4</sup> Generally, HCSWs are considered domestic employees of home care service recipients (HCSR).<sup>5</sup> However, some HCSWs are treated as employees of an agency or as self-employed independent contractors.

The employment tax rules and regulations are complex and applying those rules in situations where the employer-employee relationship involves a home care service recipient and a home care service worker can be difficult. This absence of clarity creates compliance problems for employers and administrative challenges for the IRS. The National Taxpayer Advocate has identified several systemic problems with respect to the employment tax treatment of in-home care service recipients, including the following:

- Classification by the IRS of HCSRs as common law employers and the misclassification of HCSWs as independent contractors often leads to confusion and significant employ-

<sup>1</sup> In 2003, nearly 2.6 million individuals received home and community-based services (HCBS). 978,155 individuals were served through HCBS 1915(c) waivers, 860,601 individuals received care through the home health benefits, and 711,249 individuals received personal care services through the optional state benefit plan. See Kaiser Commission on Medicaid and the Uninsured, *Medicaid 1915(c) Home and Community-Based Service Programs: Data Update* (Dec. 2006).

<sup>2</sup> Sources of funds include, but are not limited to: Medicaid, Grants to States for Old-Age Assistance (42 USC, Chapter 7, Subchapter I), Grants to States for Aid to Permanently and Totally Disabled (42 USC, Chapter 7, Subchapter XIV), Grants to States for Medical Assistance Programs (42 USC, Chapter 7, Subchapter XIX), and Social Block Grants (42 USC, Chapter 7, Subchapter XX). Funds may be also provided directly from the state budgets.

<sup>3</sup> Office of Inspector General, Department of Health and Human Services, *States' Requirements for Medicaid-Funded Personal Care Attendants*, OEI-07-05-00250 (revised Dec. 2006). The Department of Health and Human Services, which provides the federal funding for these programs, typically identifies the programs as person-centered and self-directed and intended to allow the service recipient to participate as fully as possible in his or her care.

<sup>4</sup> An estimated 578,290 individuals were employed as personal and home care aides in 2006. See Bureau of Labor Statistics, U.S. Department of Labor, *2006 National Occupational Employment and Wage Estimates*, available online at <http://www.bls.gov/oes/current/oes399021.htm>.

<sup>5</sup> See IRS Notice 2003-70, 2003-2 C.B. 916, *amplifying and modifying* IRS Notice 95-18; Rev. Proc. 80-4.

ment tax consequences for both recipients and workers, who may incur employment tax debts for a number of years, including accrued interest and penalties.

- Lack of clear IRS guidance that adequately and timely addresses the failures of intermediary service organizations (ISOs) contracted by government agencies to handle employment tax liabilities to properly report, file, and pay employment taxes often causes substantial hardship for elderly and disabled HCSRs, as they remain ultimately liable for the taxes, interest, and penalties.<sup>6</sup>

## Analysis of Problem

### Background

In 2001, the National Taxpayer Advocate raised concerns about the disparate tax treatment of HCSWs and the classification of service recipients as common law employers.<sup>7</sup> The National Taxpayer Advocate proposed a legislative change to shift the liability for employment taxes from the service recipients, who are generally considered common law employers under current law, to the administrators of HCSR funding, including (but not limited to) states, state agencies, or ISOs, regardless of the original source of funding. The National Taxpayer Advocate further proposed an amendment to Internal Revenue Code (IRC) § 3121(d) to clarify that HCSWs are employees rather than independent contractors.<sup>8</sup>

### Who Is the “Employer” for Employment Tax Purposes?

Under present law, the determination of who is liable for withholding, paying, and reporting federal employment taxes begins with the identification of the common law employer.<sup>9</sup> Generally, this determination is based on all facts and circumstances, taking into consideration whether the employer has the right to direct and control the method and means by which an employee performs the services.<sup>10</sup>

<sup>6</sup> In 2003, the IRS released guidance for state and local government agencies serving as agents, under IRC § 3504, for elderly and disabled individuals receiving home care services. See Notice 2003-70, 2003-2 C.B. 916. That Notice contained a proposed revenue procedure, but the IRS has not issued any guidance since then. Moreover, the proposed revenue procedure does not adequately cover all necessary aspects of the tax consequences of the HCSW program.

<sup>7</sup> National Taxpayer Advocate 2001 Annual Report to Congress 193.

<sup>8</sup> See Additional Legislative Recommendation, *Home Care Service Workers*, *infra*. Essentially, the National Taxpayer Advocate recommended enactment of a new code section removing liability for employment taxes from the common law employer (here, the service recipient) and deeming the administrator of the home care service funding (defined as states, their agencies, or intermediary service organizations, regardless of the funding) as the responsible party to withhold, report, and pay taxes on behalf of the care providers. See also National Taxpayer Advocate 2001 Annual Report to Congress 193. In 2002, Senator Jeff Bingaman introduced a bill to amend the Internal Revenue Code to clarify that any HCSW is an employee of the administrator of home-based service worker program funding. S. 2129, 107<sup>th</sup> Cong. 2d Sess. (2002).

<sup>9</sup> IRC § 3401(d) defines “employer” as “the person for whom an individual performs any services, of whatever nature as an employee of such person, except that if the person for whom the individual performs the services does not have control of the payment of wages for such services, the term “employer” means the person having control of the payment of such wages.” The common law test for determining whether an employee-employer relationship exists consists of a balancing of factors, including payment of wages, control of functions, training, hiring, supervising, and setting the hours of work. See Treas. Reg. § 31.3121(d)-1; see also Rev. Rul. 87-41.

<sup>10</sup> See IRC § 3121(d)(2).

In 1987, the IRS published a 20-factor test for use in determining whether an employer-employee relationship exists.<sup>11</sup> This guidance was based on an examination of court decisions and rulings concerning indicia of common law employment. Eventually, the complexity of applying the 20-factor test and changes in certain business practices led to a new approach for employer classification.<sup>12</sup> In 2004, the IRS sought to group the 20 factors into three general categories – behavioral control, financial control, and relationship of the parties.<sup>13</sup>

However, the new formulation does not substantially simplify worker classification determinations. Elderly and disabled HCSRs who fall into the category of common law employers are still required to apply highly technical and complex employment tax rules to determine their employer status and the resulting withholding, depositing, reporting, filing, and employment tax payment responsibilities.<sup>14</sup>

If a HCSR is the common law employer of a HCSW, then the service recipient is generally liable for applicable Federal Insurance Contributions Act (FICA) tax, Federal Unemployment Tax Act (FUTA), and federal income tax withholding under the rules applying to household or domestic employees. Under current law, if an HCSW earns more than the current threshold amount of \$1,500 in a year, FICA taxes are imposed on those wages.<sup>15</sup> This limit is applied on an employer-by-employer basis. FUTA taxes are owed on the first \$7,000 of wages per employee if the employer pays more than \$1,000 in any quarter in the current or previous year in cash wages for home care services.<sup>16</sup> Although employers generally are required to withhold federal income taxes, the law provides an exception for household employers, so withholding of federal income tax by HCSRs is not required unless the parties agree to it. HCSRs may report employment taxes annually on Schedule H rather than quarterly on Form 941.<sup>17</sup>

### *Designating Third Party Agents and Subagents*

Several options may be offered to a HCSR to have a third party payer perform the payroll functions. Typically, the available options depend upon the program through which

<sup>11</sup> See Rev. Rul. 87-41.

<sup>12</sup> See IRS Information Letter 2004-0087 (June 30, 2004).

<sup>13</sup> See IRS, *Independent Contractor or Employee? Training Materials*, Training 3320-102 (Oct. 1996) TPDS 84238; IRS Publication 15-A, *Employer's Supplemental Tax Guide* (Jan. 2007); see also Joint Committee on Taxation, *Present Law and Background Relating to Worker Classification for Federal Tax Purposes*, JCX-26-07 (May 7, 2007). Generally, whether the service recipient is the employer depends upon how the state or ISO operates its program. Typically, the state will advise the service recipient how to handle the employment taxes, either with a third party agent or directly with the state.

<sup>14</sup> Employers are required to withhold federal and state income taxes, Medicare taxes, and Social Security taxes from their employees' wages and pay a matching amount of Medicare and Social Security taxes on behalf of their employees. See IRC §§ 3101, 3102, 3111-3113, and 3121-3128 (Federal Insurance Contributions Act); IRC §§ 3201, 3202, 3211, 3221, 3231-3233, and 3241 (Railroad Retirement Tax Act); IRC §§ 3301-3311 (Federal Unemployment Tax Act); IRC §§ 3401-3407 (collection of income at source on wages); IRC §§ 3501-3511 (general provisions related to employment taxes); IRC § 6011 (general requirement of return, statement, or list); IRC § 6051 (receipt for employees); and IRC § 6302(g) (deposits of Social Security taxes).

<sup>15</sup> See IRC §§ 3121(a)(7)(B) and (x); see also SSA Notice No. 2006 SSA-0088, *Cost-of-Living Increase and Other Determinations for 2007*, 71 FR 62636; IRS Notice 2006-102, 2006-46 I.R.B. 909.

<sup>16</sup> IRC §§ 3306(a)(3) and (b).

<sup>17</sup> See Publication 926, *Household Employer's Tax Guide* (Jan. 2007) and Publication 15, *Circular E, Employer's Tax Guide* (Jan. 2007).

the HCSR receives services. Whether the third party is liable for the employment taxes depends upon in what capacity the third party acts.<sup>18</sup>

IRC § 3504 allows an employer to designate an agent to file returns and make deposits or payments of employment taxes. When an agent acts under IRC § 3504, both the employer and the agent are liable for the employment taxes.

- **Non-governmental party appointed as a § 3504 agent.** The HCSR may appoint a non-governmental party as its agent under IRC § 3504. In this case, IRS guidance requires the employer to appoint the agent using Form 2678, Employer/Payer Appointment of Agent, which the agent must also complete and file with the IRS.<sup>19</sup> Both the agent and the employer are liable for the employment taxes.
- **State serves as a designated agent.** In some cases, the state or local government (or its health and welfare agency) may serve as the HCSR's agent under IRC § 3504. IRS guidance does not require the employer to appoint the state using the Form 2678 and the state or local agency is not required to file a Form 2678 with IRS for each service recipient. Instead, the program enrollment forms will serve as the appointment of the agent and the state or local entity is required to advise the IRS in writing of the its appointment as an agent.<sup>20</sup> The state or local government, as a section 3504 agent, as well as the employer, are liable for employment taxes.<sup>21</sup>
- **State appoints a subagent.** A state or local government that is a § 3504 agent of the HCSR may, in turn, designate a sub-agent under IRC § 3504. The state or local government must appoint the subagent using a Form 2678 which the subagent must complete and file with the IRS. In such instances, the state, the sub-agent, and the employer are liable for employment taxes.<sup>22</sup>
- **State hires a reporting agent.** A state or local government acting as a § 3504 agent may hire a reporting agent or a payroll service provider. In this case, the state continues to act as the IRC § 3504 agent. The reporting agent is not liable for the employment taxes.<sup>23</sup>

<sup>18</sup> For in-depth discussion of third party payers, see Most Serious Problem, *Third Party Payers*, *supra*.

<sup>19</sup> See Notice 2003-70; Notice 95-18; Rev. Proc. 80-4; Rev. Proc. 70-6.

<sup>20</sup> Notice 2003-70, Q&A 6 and 7 (Oct. 27, 2003).

<sup>21</sup> IRS Notice 2003-70, *Proposed Revenue Procedure Regarding Home care Service Procedures*, provides the most recent guidance to state and local government agencies on how they can serve as agents under IRC § 3504 for disabled individuals and other welfare recipients who employ home care service providers in their homes. In addition, it provides guidance for state and local government agencies that contract program administration out to third party vendors. Notice 2003-70 modifies and supersedes, in part, Rev. Proc. 70-6 and modifies and amplifies Rev. Proc. 80-4. Rev. Proc. 80-4 amplifies Rev. Proc. 70-6 and applies only to state and local health and welfare agencies seeking to act as IRC § 3504 agents for welfare recipients who become the employers of individuals furnished by the agencies to provide in-home domestic service for the welfare recipients. Notice 95-18 modifies Rev. Proc. 70-6 and amplifies Rev. Proc. 80-4. State and local government health and welfare agencies that act as agents pursuant to Rev. Proc. 80-4 must obtain a separate Employer Identification Number (EIN) (in addition to the one used to report taxes of its own employees) for use in reporting taxes on behalf of all of the service recipients for whom it acts as an agent. Notice 2003-70 reviews, through a series of questions and answers, the operation of the specialized procedures and incorporates aspects of the procedures added by Notice 95-18.

<sup>22</sup> See Notice 2003-70, Q&A 25 and 26.

<sup>23</sup> See *id.*, Q&A 18 and 19.

In all of the instances above, the HCSR – as the common law employer – remains liable to the IRS for employment taxes.<sup>24</sup>

### *HCSRs Experience Problems as a Result of the Recent Change in the IRS Employment Tax Collection Policy and Gaps in IRS Processes*

If a state or local agency contracts out the payroll functions of its program to an ISO, the ISO must follow the rules of Rev. Proc. 70-6, as modified by Notice 2003-70, in order to become designated as an agent that can report and pay taxes for the HCSR. In this case, the service recipient designates the ISO as its agent and the ISO is permitted to report employment taxes on an aggregate basis under one Employer Identification Number (EIN) of the state agency. Some states do not want to be involved in the payroll function at all, choosing not to be an agent under the relaxed procedures of Notice 2003-70, which may affect their liability for employment taxes. Consequently, many ISOs become the agents directly for the HCSR.<sup>25</sup> Such direct ISO agents cannot file and pay aggregate FUTA taxes. Instead, they must file for each HCSR using Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return.

Current IRS procedures require sophisticated knowledge and understanding of Notice 2003-70 and Rev. Proc. 70-6 that some ISOs lack, resulting in inconsistent practices under both guidance sources. Currently, the IRS falls short in timely reacting to ISO failures to understand and follow the published IRS guidance. The IRS acknowledges that some state and local governments and the ISOs that administer these programs are not following the published IRS guidance, leading to increased confusion about filing requirements and, in some cases, to unwarranted collection and enforcement activities against elderly and disabled individuals.<sup>26</sup> Program administrators assert they have been asking the IRS for more than a decade to simplify and streamline procedures to enable ISOs and participants to comply with tax laws.<sup>27</sup>

Until recently, IRS systems were not able to accurately identify the number of ISOs and the number of HCSRs who use these agents.<sup>28</sup> Prior to January 2007, the IRS did not effectively track HCSR-agent relationships established under IRC § 3504. Furthermore, the IRS was unable to identify the specific HCSRs included in the aggregate returns filed by ISOs on behalf of multiple clients.<sup>29</sup> Beginning in January 2007, the IRS began to systemically record the HCSR-agent relationship information for current filings. This will allow for the retrieval of appointment information, revocations, and cross reference data.

<sup>24</sup> See Notice 2003-70.

<sup>25</sup> See *id.*

<sup>26</sup> IRS Collection Memorandum, *Collection Activity on In-Home Care Recipient Cases* (Sept. 18, 2006).

<sup>27</sup> James R. Knickman and Robyn I. Stone, *The Public/Private Partnership Behind the Cash and Counseling Demonstration and Evaluation: Its Origins, Challenges, and Unresolved Issues*, Health Service Research, 362 Volume 42, Issue 1 (Feb. 1, 2007).

<sup>28</sup> See Small Business/Self-Employed Division (SB/SE) response to TAS research request (Oct. 25, 2007).

<sup>29</sup> See SB/SE, *Employment Tax Strategy Template* (Rev. May 7, 2007).

### *Example of ISO filing errors compounded by gaps in IRS processing*

State X contracted with an ISO to administer an in-home care service program serving 2,000 elderly and disabled individuals. Before 2004, the ISO filed separate employment tax returns for each individual to report payroll taxes of the home care service workers. In 2004, the ISO began filing a Form 941 return in the aggregate for all clients under its EIN and separate Forms 940 under each client's name and EIN. When a Form 940 posts to a taxpayer's account, a Form 941 filing requirement is triggered if one does not already exist. We understand that the link between the Form 941 and Form 940 serves a compliance purpose, as most taxpayers who file Form 940 must also file Form 941. However, when an agent operating under IRC § 3504 files Form 941 in the aggregate and files separate Forms 940 for each client using that client's name and EIN, the IRS looks to the individual client for a Form 941 – even though the client is not required to file one.

In these cases, the open Form 941 filing requirement on the client's account often generated Tax Delinquency Investigations, which resulted in collection activities such as inappropriate notices and IRC § 6020(b) assessments. Indeed, the IRS assessed taxes under § 6020(b), filed notices of federal tax lien, issued bank levies and levies against Social Security benefit payments, and entered into installment agreements with HCSRs, even though the taxes were paid by the ISO. The IRS attributes some of the erroneous account actions to the ISO not following the proper guidance and to systemic problems (*e.g.*, unnecessary open filing requirements on the elderly and disabled accounts in the absence of a link on the ISO's account to the service recipients' accounts).

During FY 2006 and FY 2007, TAS persuaded the IRS to temporarily stop collection action with respect to all affected taxpayers. TAS and the IRS worked closely with the ISO to verify all taxes were properly reported and paid. TAS also worked with the IRS Collection function to abate the erroneously assessed tax, interest, and penalties, release liens and levies, and refund levy proceeds for approximately 2,000 elderly and disabled taxpayers.<sup>30</sup>

### **Elderly and Disabled Home Care Service Recipients Lack Indicia of a Common Law Employer in Many Cases**

As described above, the liability for employment taxes is imposed on elderly and disabled individuals who are the common law employers of home care service workers. However, the common law test does not consider whether the individual is financially able to accept that responsibility. Although the goal of these programs is for the service recipient to

<sup>30</sup> In FY 2006 and FY 2007, the TAS Office of Systemic Advocacy and the TAS Case Advocacy function worked the issues as an immediate intervention and opened a case on the ISO to ensure consistent case resolution for all affected taxpayers. In addition, TAS Case Advocacy provided individual case resolution to taxpayers who sought TAS assistance separately or through their congressional offices. The Collection function worked closely with TAS to identify cases where HCSRs were erroneously assessed taxes due to mistakes made by ISOs. Collection action was withheld on most of these cases while Automated Collection System personnel, Accounts Management, and TAS worked to adjust the accounts.



participate as fully as possible in his or her care, the elderly and disabled individuals who qualify for this type of social service assistance traditionally have very little control over the direct payment of funds for services rendered. In most cases, the social service agency establishes the conditions of employment. Consequently, the recipients of services lack sufficient control over the manner in which the home care services are rendered.

The design and implementation of home care service programs differ from state to state with some states using ISOs to assume functions that employers often undertake, including:

- Obtaining the EIN on behalf of the home care service recipients;
- Hiring the home care workers;
- Paying the home care workers; and
- Withholding and remitting payroll taxes on behalf of the workers and filing payroll tax returns with the IRS.

While some of these functions are not automatically indicative of employer status, they are functions often performed by employers. The IRS generally takes the position that the service recipients are the employers for purposes of collecting delinquencies, even if these elderly and disabled taxpayers bear few of the indicia of common law employers.<sup>31</sup> States, local government agencies, and ISOs often fail to follow the guidance that allows appointment of an agent under IRC § 3504, because such an appointment is not mandatory. Where an agent has not been designated under IRC § 3504 in accordance with the applicable procedures, the agent may not report the payroll taxes on an aggregate return; instead, each service recipient is responsible for filing a return under his or her EIN. These individual returns are usually prepared by the ISO contracted to administer the program or a reporting agent. The IRS's position in such cases is that, where each HCSR is responsible for filing a return under his own EIN, the delinquent investigations and assessed liabilities on the individual accounts of the HCSRs may be appropriate.<sup>32</sup> Thus, the impact on the elderly and disabled individuals becomes a financial as well as an administrative burden for those with the least resources to address the concern.

### **HCSRs Experience Problems as a Result of Downstream Impact of ISO and Reporting Agent Failures to Properly Report, File, and Pay Employment Taxes**

Elderly and disabled home care service recipients can suffer substantial financial hardships when state and local government agencies contract out program responsibilities, including payroll functions, to ISOs. These entities act as agents for service recipients, many of whom are not prepared to handle payroll duties. However, when the ISO fails to properly

<sup>31</sup> See Notice 2003-70, Q&A 5.

<sup>32</sup> IRS Collection Memorandum, *Collection Activity on In-Home Care Recipient Cases* (Sept. 18, 2006).

report, file, and pay employment taxes, the elderly and disabled HCSR remains liable for the tax, interest, and penalties.

The IRS recently identified a significant number of cases involving elderly and disabled in-home care recipients affected by purported ISO failures.<sup>33</sup> In many of these cases, the ISOs failed to properly report and pay employment taxes on wages paid to the home care service workers and failed to properly file the related employment tax returns and the annual wage and tax statements. Consequently, the IRS's records reflect tax delinquencies on elderly and disabled taxpayers' accounts. These failures result in substantial downstream impact on elderly and disabled taxpayers, who become subject to assessment and collection of employment taxes and civil penalties.

In many of the cases, the IRS took unwarranted collection and enforcement actions against the elderly and disabled taxpayers. The IRS filed notices of federal tax lien, issued levies on the elderly and disabled individuals' personal bank accounts, and levied their monthly Social Security benefits, even though many elderly and disabled taxpayers depend on these funds to pay rent and buy food and medicine. TAS and the IRS provided relief to many of these taxpayers in various states.<sup>34</sup>

#### *Example of reporting agent failure to properly report and pay employment taxes*

State Y administered a variety of home care service programs for thousands of its elderly and disabled residents. It contracted out the administration of the program to several ISOs and hired a reporting agent to administer payroll functions, including compliance with federal, state, and local employment tax requirements.

The reporting agent filed individual employment tax returns for each service recipient. When the state terminated the contract with the reporting agent, federal tax delinquencies developed on thousands of service recipient accounts. The elderly and disabled individuals' accounts reflect delinquencies for FICA and FUTA taxes, as well as taxpayer delinquency inquiries processed through the automated IRC § 6020(b) program that generates tax assessments.<sup>35</sup> The IRS filed notices of federal tax lien, issued levies on bank accounts, and levied on Social Security benefit payments. In some cases, the reporting agent failed to deposit the correct amount of federal employment taxes timely, leading to unpaid tax liabilities and penalties against these taxpayers.

<sup>33</sup> IRS Collection Memorandum, *Collection Activity on In-Home Care Recipient Cases* (Sept. 18, 2006).

<sup>34</sup> In FY 2006 and FY 2007, TAS and the IRS identified over 25,000 elderly and disabled taxpayers potentially subject to collection activity. TAS worked closely with various IRS Collection and Customer Service functions (Automated Collection System, Federal Payment Levy Program, and Accounts Management) to resolve the myriad account issues. The TAS Office of Systemic Advocacy opened three immediate interventions and an advocacy project. Local TAS offices in Pittsburgh and St. Louis resolved more than 300 individual cases.

<sup>35</sup> Certain employment tax nonfilings are subject to assessment using IRC § 6020(b) authority if the taxpayer does not resolve the delinquency in response to delinquency notices. These assessments are made in a manner similar to the Automated Substitute for Return program but are not subject to deficiency procedures.

The IRS agreed to stop collection action temporarily for all affected taxpayers. For those taxpayers (*i.e.*, the care recipients) whose account issues could be reconciled, the IRS abated tax, penalties, and interest. For taxpayers whose account issues could not be reconciled, TAS is currently working with the ISOs and the reporting agent to resolve them. In some of these cases, however, the reporting agent disputes the liability, taxpayers continue to be subject to levy on their Social Security benefit payments, and the Small Business/Self-Employed division (SB/SE) has advised TAS that it no longer has the resources to provide much needed assistance in the remaining cases.<sup>36</sup>

The National Taxpayer Advocate is very concerned about these unresolved cases, specifically with respect to further enforcement action against these taxpayers.

### Conclusion

Current law does not allow the IRS to classify state agencies or designated ISOs to be the common law employers of HCSWs with sole liability for employment taxes with respect to their wages.<sup>37</sup> When state agencies or ISOs administer funds that pay for home care services but the HCSRs are the employers under common law standards, the recipients of home care services face substantial confusion and unreasonable burdens. Many elderly and disabled HCSRs have neither the resources nor the background to perform the fiscal and administrative tasks required to comply with employment tax laws. While the National Taxpayer Advocate supports a statutory change to address this problem,<sup>38</sup> we believe the IRS can take significant steps under existing law to mitigate the collection and assessment aspects of the problem.<sup>39</sup> The IRS should make changes to its current collection policy to indefinitely suspend assessment and collection of employment tax from elderly and disabled HCSRs resulting from ISO defaults, while actively pursuing collection of the unpaid employment tax liability from the ISOs that are jointly and severally liable under IRC § 3504. The IRS should recognize that state agencies and designated ISOs, rather than HCSRs, may in many cases bear the indicia of a common law employer and are responsible for reporting, withholding, and paying employment taxes, resulting from the administration of government-funded welfare programs. The National Taxpayer Advocate recommends that the IRS simplify its processes for state and local agencies managing welfare-funded home care programs for HCSRs and develop uniform and mandatory third party application and filing guidelines for use by IRS campuses across the country.

<sup>36</sup> *In-Home Care Worker Project*, telephone interview with SB/SE Collection Policy Analyst (Sept. 19, 2007).

<sup>37</sup> See generally Revenue Act of 1978, § 530, 26 U.S.C. § 3401, Pub. L. No. 95-600, 92 Stat. 2763 (1978); as amended Pub. L. No. 96-167, § 9(d), 93 Stat. 1278 (1979); Pub. L. No. 96-541, § 1, 94 Stat. 3204 (1980); Pub. L. No. 97-248, Title II, § 269(c)(1), (2), 96 Stat. 552 (1982); Pub. L. No. 99-514, § 2, Title XVII, § 1706(a), 100 Stat. 2095, 2781 (1986); Pub. L. No. 104-188, Title I, § 1122(a), 110 Stat. 1766 (1996); Pub. L. No. 109-280, Title VIII, § 864(a), 120 Stat. 1024 (2006).

<sup>38</sup> See 2001 National Taxpayer Advocate Annual Report to Congress 193, Key Legislative Recommendation, *Home-Based Service Workers*. See also Additional Legislative Recommendation, *Home Care Service Workers*, *infra*.

<sup>39</sup> IRC § 3510(e) authorizes regulations for the collection and assessment of employment taxes due from domestic employers.

## IRS Comments

The payroll tax issues affecting home health care service workers (HCSWs) and home care service recipients (HCSRs) are enmeshed with the larger system of health care delivery to disabled individuals. In 2001, through the issuance of Executive Order 13217, the Administration created and promoted the concept of home health care with the “New Freedom Initiative.” The President’s initiative was intended to “ensure that all Americans have the opportunity to live close to their families and friends, to live more independently...” Consequently, HCSRs are institutionalized, resulting in a huge and continuing expansion of the home health care industry with a related increase in the number of individual HCSWs.

In response to the President’s New Freedom Initiative, and the Supreme Court’s decision in *Olmstead*, the states, with the help of Health and Human Services (HHS) and private foundations, created “self directed” care programs. Self directed care is defined as a state Medicaid program that presents individuals with the option to control and direct Medicaid funds in an individual budget. The Centers for Medicare & Medicaid Services (CMS) have set out the following requirements for a comprehensive, self-directed program:

- Person-Centered Planning: A process, directed by the participant, intended to identify the strengths, capacities, preferences, needs and desired outcomes of the participant.
- Individual Budgeting: The total dollar value of the services and supports, as specified in the plan of care, under the control and direction of the program participant.
- Self-directed Services and Supports: A system of activities that assist the participant to develop, implement and manage the support services identified in his/her individual budget.
- Quality Assurance and Quality Improvement.

The implementation plans for these programs vary by state, have different names, and involve different Medicaid/Medicare programs. Certain programs require the participants to use an agent and these programs emphasize that the HCSRs are common law employers of their HCSWs. The Agent “manages both the workers’ payroll and the payment of goods and services...maximizes the program participants’ independence and control while ensuring federal and state tax, labor and worker’s compensation insurance compliance and program accountability.” Thus, the essence of self-directed care is to give the HCSR control over his or her care while at the same time HHS has emphasized that the HCSWs are employees of the HCSR. This, in turn, provides social security coverage to those workers via the payroll tax systems.

## Employer Classification

The IRS has grappled with the employment tax treatment of the HCSWs since at least 1980. At that time the states provided the workers directly to the HCSRs and were concerned that the workers would assert that they were state “employees” eligible for state

provided benefits. To address that concern, the IRS issued Revenue Procedure 80-4 which provided that “in some instances, workers who perform in-home domestic services paid for with funds supplied by such state or local agencies are the employees of the welfare recipients who receive those services.” The revenue procedure then sets forth the procedures for state and local health and welfare agents to act as agents under § 3504 for HCSRs who are considered the employers of the HCSWs. Rev. Proc. 80-4 (and the earlier Rev. Proc. 70-6) were subsequently updated by Notice 2003-70. This notice recognized that the industry had evolved to include third parties, in addition to the states, that participate in various aspects of processing federal grants and state funds, working with HCSRs to establish care plans, placing HCSWs in homes, and administering payroll for the HCSWs.

The IRS recognizes that there may be instances in which the HCSR is not the common law employer. However, under current practices, a state will hire a third party to handle the payroll and the HCSR will designate that third party as his or her section 3504 agent on a Form 2678. This arrangement, which is authorized for common law employers by Revenue Procedure 70-6, as modified by Notice 2003-70, works well as long as the third party understands and follows the rules associated with the reporting, filing, and payment of employment taxes. Engaging third parties also comports with the Administration’s New Freedom Initiative to promote consumer direction and control by the HCSR. It takes the payroll tax burden away from the HCSR and recognizes that states typically hire third parties to provide payroll.

Under current law, whether the HCSR is the employer depends upon the application of the common law test. The common law test applies 20 factors to ascertain whether the HCSR has the right to direct and control the HCSW. The common law test is not unique to HCSRs and HCSWs; it applies to all taxpayers. The IRS does not have the authority to deem a party in any employment situation to be the common law employer. The particular facts of each employment relationship must be examined in order to reach a conclusion about whether an employer and employee relationship exists. In addition, section 530 of the Revenue Act of 1978 precludes the IRS from issuing revenue rulings or regulations on employment status.

In certain cases, a “statutory employer”, within the meaning of section 3401(d)(1), will be liable for employment taxes rather than the common law employer. For *income tax* withholding purposes the term “employer” means the person for whom an individual performs any service, of whatever nature, as the employee of such person [§ 3401(d)]. However, if the person for whom the individual performs the services does not have control of the payment of the wages for such services, the term “employer” means the person having control of the payment of such wages [§ 3401(d)(1)]. Although there is no similar provision for FICA or FUTA, case law has extended the application of statutory employer to FICA and FUTA taxes. The IRS and the courts have narrowly interpreted this provision and it requires an examination of the particular facts to determine whether the statutory employer

is liable for the employment taxes. Thus, it is not possible to say with certainty whether a state or other third party would be characterized as a statutory employer.

The authorized agent appointed under § 3504 files an aggregate return under its own Employer Identification Number (EIN), reporting FICA, Medicare, and federal income tax. However, the agents appointed under § 3504 are not authorized to file an aggregate Form 940 for their clients. The only exception arises when the agent appointed is a state or local governmental entity reporting wages and associated taxes paid on behalf of a “service recipient” household employer to a “chore-worker.” These wages may be reported on an aggregate Form 940 if the requirements of Notice 2003-70 are met. The IRS identified the additional burden that the filing of the individual Forms 940 has caused the HCSR taxpayers and their authorized agents. As a result, the IRS is working with external stakeholders such as HHS/CMS, the National Association of State Medicaid Directors, and the Department of Labor to determine the feasibility of accepting Forms 940 with aggregate FUTA wages and taxes reported on behalf of HCSRs who are household employers receiving Medicaid funds.

HHS policy affords service recipients as much discretion as possible over the services and program operation, allows them to choose the HCSW and direct the services to be performed, and it is accordingly reasonable for state agencies to conclude that HCSRs will be common law employers. As such, they would usually be responsible for reporting and paying employment taxes with respect to the wages paid to their HCSWs. Many of the states have sought to enlist intermediary service organizations (ISOs) to assist HCSRs in securing in-home service providers and with other administrative functions for the program, including, but not limited to, reporting and payment of employment taxes.

The variation in program operation across the 50 states (*e.g.*, who has discretion to select the individual who will be the HCSW, who has discretion to prescribe the tasks to be performed and the way they should be performed, who controls the bank account from which the HCSW is paid, who can exercise discretion on the HCSR’s behalf if the HCSR is not capable of communicating for him or herself), may produce different answers under different programs. To provide some assistance with the reporting and payment of employment taxes where the HCSR is determined to be the common law employer, the Service has proposed guidance (Notice 2003-70) on how a third party, such as an ISO, can be involved in the reporting and payment of the employment taxes.

The IRS agrees that the law is confusing and creates a complex set of options for third parties. The IRS will continue working with HHS and the states to see how it can develop clearer tools that will better educate ISOs and other third parties on the reporting and payment options and requirements in this area.

### IRS Procedures

While the IRS agrees that the employment tax rules and regulations are complex, and applying those rules in situations where the employer-employee relationship involves a HCSR

and a HCSW can be difficult and sometimes challenging, there is little that can be done outside of legislative change. We recognize that outreach and education in this area could be expanded to facilitate a better understanding of the regulations, and to help payroll service vendors better understand and follow guidance and procedures for filing aggregate payroll tax returns.

The problems HCSRs experience are generally a result of ISO and Payroll Service Provider failing to properly report, file, and pay employment taxes. We agree that due to inappropriately filed aggregate returns, assessments and collection activity were undertaken on some elderly and disabled HCSRs.

Errors, mistakes, or fraudulent practices in filing payroll taxes for HCSRs, as well as for the public in general, can result in cases being sent inappropriately to the Collection function. When Collection field or service center functions identify such errors, Collection policy requires that every effort be made to correct them and abate applicable tax, penalties, and interest as warranted.<sup>40</sup>

In 2006 and 2007, Collection, working with TAS and the Office of Taxpayer Burden Reduction, identified and successfully adjusted accounts impacted by 29 vendors in three states representing nearly 23,000 taxpayer clients. In the course of resolving these problems, collection action was suspended on all identified accounts. Most of these problems were caused by payroll service vendors' failure to follow guidance with respect to their ability to file aggregate payroll tax returns.

To help eliminate or minimize such instances, in September 2006, Collection Policy issued a memorandum to its field offices alerting Collection personnel to the potential for such HCSW and HCSR problems and advising them to "stop collection activity until you determine the facts and circumstances of the case, and whether or not collection activity is appropriate." The memorandum also urged employees to "use the utmost caution and discretion on these accounts to determine the validity of the liability before taking action to secure returns or payment."<sup>41</sup>

While the vast majority of HCSRs obtain care through state and local agencies and/or designate third parties to handle pay and payroll tax matters related to HCSWs, some do not. Many elderly people employ household workers for a variety of functions and are required to follow the requirements for reporting, withholding and paying payroll taxes for them. The September 2006 Collection Policy memorandum embraces this possibility as follows:

<sup>40</sup> IRM 5.1.15.18 addresses Collection procedures for penalty abatements. See also IRM 20.1 (Penalty Adjustments) and 20.2 (Interest Adjustments). In general, penalties are abated when taxpayers request such abatements and demonstrate that there is a reasonable cause for the action that caused the penalty. Interest is abated only for a limited number of reasons, mainly related to IRS ministerial errors.

<sup>41</sup> IRS Collection Memorandum, *Collection Activity on In-home Care Recipient Cases* (Sept. 18, 2006).



It is important to note that not all state and local government agencies, their vendors, and their service recipients follow guidance that allows for the appointment of a section 3504 agent, as it is not mandatory. Therefore, rather than reporting the payroll taxes on an agent's aggregate return, each service recipient is responsible for filing a return under his or her own EIN. These returns are usually prepared and filed by a third party, such as the vendor contracted to administer the program or a reporting agent. In these cases, delinquency investigations and assessed liabilities on the individual accounts may be appropriate. We are, however, finding a number of issues on these accounts as well, such as late payments by vendors and misapplied payments. In some cases, abatement of penalties under standard criteria or other account adjustments may be in order.

Collection Policy followed up with coordinators in our seven Collection area offices in September 2007 to determine if any new cases involving payroll tax issues of HCSWs or HCSRs had come to their attention, but all reported that there had been no such activity. This corresponds with informal reports from TAS.

In addition to maintaining resources in Collection Policy to address potential problems, Collection has taken steps to proactively work with a number of states to mitigate problems created by unscrupulous or incompetent home care operators and agencies.

As an example, the state of North Carolina and the IRS are exploring ways to use the Medicare/Medicaid certification and review processes to ensure payroll tax compliance as well as more efficient methods for notifying HCSRs of pending IRS action against home care agencies. This team is also developing improved outreach and educational materials for both HCSW agencies and HCSRs.

### **Intermediary Service Organizations (ISOs)**

The IRS does not believe that a lack of coordinated and consistent IRS guidance led to assessing the common law employer for non-filed returns and/or unpaid taxes; rather it was due to the EINs on record for the tax return due. The accounts may have been established with the EIN when the Form SS-4 was filed or when prior tax returns of the same type were received.

Examples were provided in the report, but did not specify whether errors were made by the ISO. We cannot be sure that if the ISO had followed the guidance as intended that the enforcement actions would have occurred. To further support the preceding statement, we have only to look to other taxpayers who rely on Forms 2678 and the guidance provided to appoint agents and we have not encountered similar problems.

In 2007 the IRS encountered problems that involved a state or local agency that had contracted the payroll functions of its program to an ISO. Under this model, the ISO must follow the rules of Revenue Procedure 70-6 as modified by Notice 2003-70 to become

designated as an agent that can report and pay taxes for the HCSR. In this case, the service recipient designates the ISO as its agent and the ISO is permitted to report employment taxes on aggregate basis under one Employer Identification Number (EIN).<sup>42</sup>

The IRS acknowledges that some state and local governments, and the ISOs that administer these programs, may find it difficult to correctly perform the payroll functions related to the program because they do not completely understand the requirements of Rev. Proc. 70-6, Rev. Proc. 80-4 and Notice 2003-70. This lack of understanding has resulted in increased confusion about filing requirements and, in some cases, collection and enforcement activities against elderly and disabled individuals. In an effort to minimize enforcement activities against these individuals and all other Form 2678 filers, effective January 1, 2007, the IRS initiated the use of specific Transaction and Action Codes on the accounts of both the employer and the agents. Systemic processing now matches return filings to the accounts based on the codes input on receipt of Forms 2678. Resource limitations did not allow for the input of Forms 2678 received prior to that date. However as of January 1, 2007 the IRS:

- Systemically recognizes and records the information from Form 2678 (or its substitute) to identify agents and employers filing employment tax returns under the provisions of § 3504;
- Can systemically retrieve appointment information, track revocations of appointment, or cross-reference employers' and agents' accounts by running extracts using the specific Transaction and Action codes assigned to the accounts;
- Is able to determine whether the agent or the employer is filing returns in compliance with employment tax rules and regulations if the Form 2678 was completed accurately and received on or after January 1, 2007; and
- Is not currently able to determine whether the amount of taxes reported and paid is correct. However, SB/SE Employment Tax Policy is investigating the feasibility of methods to correct this situation.

In summary, the IRS agrees that it encountered some problems over the last several years. However, actions were taken to minimize potential problems for HCSRs whose Form 2678 was filed after January 1, 2007. In addition, to eliminate confusion in this area, the IRS will consider developing outreach materials specific to the home health care industry and will continue its ongoing work with HHS to enhance employment tax compliance.

<sup>42</sup> See Notice 2003-70.

## Taxpayer Advocate Service Comments

We appreciate and are pleased with the IRS comments. It appears that the IRS and the National Taxpayer Advocate agree on many issues and concerns in the report. We note that the IRS response details a number of remedial actions in place or underway that will address many of our concerns. The National Taxpayer Advocate has proposed a series of recommendations that, if adopted, will complement and bolster the actions taken by the IRS to significantly mitigate the problems affecting home care service recipients. Still, some issues warrant a further response or clarification.

### *Employer Classification*

By its own admission, for almost 30 years, the IRS has wrestled with the employment tax treatment of the HCSRs. As the home healthcare industry and the government-funded programs have evolved to include third parties, the prescribed employer-employee relationship has changed drastically. In 1987, the IRS published a 20-factor test for use as an analytical tool in determining whether an employer-employee relationship exists.<sup>43</sup> Eventually, the complexity of applying the 20-factor test and changes in certain business practices led to a new analytical approach to determining employer classification.<sup>44</sup> In 2004, the IRS provided materials that set forth an approach for analyzing facts in a given case and determining whether an employer-employee relationship exists, based upon grouping relevant facts into three general categories – behavioral control, financial control, and relationship of the parties.<sup>45</sup> Nonetheless, the IRS materials have general applicability and do not specifically address the issues pertinent to a home care service arrangement.

The IRS recognizes that there may be instances in which the HCSR is not the common law employer. However, the IRS has never created a detailed and specific approach that can be used to analyze diverse sets of facts and circumstances in HCSR-HCSW relationships. We believe that such an analytical tool, which focuses on specific facts and circumstances attributable to the HCSR-HCSW relationships, should have a significant and positive impact on this and other aspects of the problem.

### *IRS Procedures*

The IRS agrees that current employment tax rules and regulations are complex, and applying those rules in situations where the employer-employee relationship involves a HCSR and a HCSW is challenging for all parties involved. The IRS also agrees that the law is confusing and creates a complex set of options for third parties. However, the IRS does not believe that a lack of coordinated and consistent IRS guidance led to assessing the common

<sup>43</sup> See Rev. Rul. 87-41.

<sup>44</sup> See IRS Information Letter 2004-0087 (June 30, 2004).

<sup>45</sup> See IRS *Independent Contractor or Employee? Training Materials*, Training 3320-102 (Oct. 1996) TPDS 84238I; IRS Publication 15-A, *Employer's Supplemental Tax Guide* (last revised Jan. 2007); see also Present Law and Background Relating to Worker Classification for Federal Tax Purposes, Joint Committee on Taxation Report, JCX-26-07 (May 7, 2007).

law employer for nonfiled returns and/or unpaid taxes. Further, the IRS response suggests there is little that can be done to address the problem short of a legislative change. While supporting a statutory change to address the problem, we also believe the current IRS employment tax collection policy, as well as gaps in IRS processes designed to minimize inappropriate collection activity, create additional confusion.<sup>46</sup> We have identified certain steps the IRS can take to mitigate the collection and assessment part of the problem.

For example, the IRS admits the different filing allowances under IRC § 3504 create confusion and result in unnecessary burden for the HCSRs. Under IRC § 3504, a designated agent files an aggregate Form 941, but individual Forms 940 for each HCSR. Prior to January 2007, IRS computer programming did not recognize this filing arrangement, which led to account delinquencies and inappropriate collection activity against HCSRs. We support the IRS's efforts to address the additional burdens that the filing of the individual Forms 940 causes HCSR taxpayers and their designated agents. TAS has been extensively involved in working with the affected HCSRs and the IRS to resolve the filing problems that often result in unwarranted collection activity. We recommend that the IRS simplify its processes for designated agents contracted to manage welfare-funded home care programs for HCSRs, and develop uniform and mandatory third party application and filing guidelines for IRS campuses across the country.

The IRS emphasizes that in 2006 and 2007, the Collection Function, TAS, and the Office of Taxpayer Burden Reduction identified and successfully adjusted accounts impacted by 29 vendors in three states representing nearly 23,000 HCSRs. However, TAS continues to work with over 20 vendors in one state representing more than 9,000 HCSRs. SB/SE advised TAS that it no longer has the resources to resolve the remaining cases. Many elderly and disabled HCSRs are still subject to inappropriate collection actions including levies against their Social Security benefit payments. The National Taxpayer Advocate is very concerned about these unresolved cases, specifically with respect to further enforcement action against elderly and disabled HCSRs.

#### *Intermediary Service Organizations (ISOs)*

The IRS acknowledges that some state and local governments, and the ISOs that administer home care programs, may find it difficult to correctly perform the related payroll functions because they do not completely grasp the requirements of Rev. Proc. 70-6, Rev. Proc. 80-4, and Notice 2003-70. We agree with the IRS that the lack of understanding of these highly technical and sophisticated rules has caused increased confusion about filing requirements and led to collection and enforcement activities against some elderly and disabled HCSRs.

We acknowledge that the IRS has implemented programming changes to systemically identify the HCSR-ISO relationship and prevent unnecessary collection activity. If an HCSR appoints a designated agent (ISO) and the agent files Form 2678 after January 1, 2007,

<sup>46</sup> See Additional Legislative Recommendation, *Home Care Service Workers, infra*.

the IRS's computer systems will link the accounts of the HCSR and the agent. Systemic processing will match return filings to both accounts, thereby minimizing inappropriate collection activity. However, for forms filed prior to January 1, 2007, the IRS computers do not link the accounts of the HCSR and the agent. We are concerned about such unlinked accounts because these HCSRs and their agents could still be subject to inappropriate collection action. We believe the IRS should do more to overcome the resource limitations preventing the linking of Forms 2678 received before January 1, 2007. It is critical that the IRS implement appropriate programming to determine whether the ISO has reported and paid the correct tax on behalf of the HCSRs.

### *Education and Outreach*

We applaud the IRS's commitment to working with HHS and the states to better educate third parties on the reporting and payment options and requirements in this area. The IRS recognizes that outreach and education in this area could be expanded to help payroll service vendors better understand and follow IRS guidance and procedures. While this may be commendable, we are concerned that the IRS may be ignoring obvious opportunities to conduct such outreach and educational services. HHS and the Centers for Medicare and Medicaid Services (CMS) regularly host workshops and conferences to educate and provide updated information for state and local government agencies, ISOs, and third parties.<sup>47</sup> Workshop topics have included several sessions on payroll functions: Key Components and Issues Related to Government and Vendor Fiscal/Employer Agent Operations and IRS Update; and The Role of Reporting Agents in the Provisions of Fiscal Employer Agent Services: Advantages, Challenges and Contracting and Evaluation Issues. TAS conducted a cursory review of more than a dozen workshops within the last five years and found only one workshop in which one IRS employee participated. We believe these workshops may be the proper forum the IRS outreach and educational effort to help taxpayers better understand their responsibilities under current law, rules and regulations.

## Recommendations

The IRS has taken or is taking specific measures to address many of the National Taxpayer Advocate's concerns. We believe these continued efforts to mitigate compliance problems for HCSRs and administrative challenges for the IRS should produce tangible and measurable benefits for both the taxpayers and the IRS. We also recognize that many of the concerns we have expressed are more difficult to resolve because of the limitations of IRS computer systems. The National Taxpayer Advocate recommends the IRS take the following actions to help elderly and disabled HCSRs and their agents to better understand

<sup>47</sup> Recently, HHS hosted a two-day workshop on how government and vendor fiscal or employer agents can build sustainable fiscal supports for self-directed service programs. Department of Health and Human Services, Office of the Assistant Secretary for Planning and Evaluation Sponsored Workshop: *Government and Vendor Fiscal Employer Agent Workshop: Building Sustainable Fiscal Supports for Self-directed Service Programs*. (Nov. 1-2, 2007).

employment tax responsibilities and minimize the downstream impact of ISO failures on elderly and disabled individuals:

- Issue a Collection Policy statement to indefinitely suspend assessment and collection of employment tax from elderly and disabled HCSRs resulting from ISO defaults, while actively pursuing collection of the unpaid employment tax liability from the ISOs that are jointly and severally liable under IRC § 3504;
- Develop analytical materials that can be used to analyze facts in a given HCSR case and determine whether an employer-employee relationship exists, based upon grouping relevant facts and circumstances attributable to the HCSR-HCSW relationships;
- Proactively develop outreach and educational materials for the home health care industry;
- Simplify IRS processes for state and local agencies managing welfare-funded home care programs for HCSRs and develop uniform and mandatory third party application and filing guidelines for use by IRS campuses across the country; and
- Implement appropriate computer programming that can currently determine whether the correct amount of taxes is reported and paid by the ISO on behalf of the HCSRs and link the accounts of the HCSRs and the ISO for Forms 2678 filed prior to January 1, 2007.

MSP  
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## Offer in Compromise

## Responsible Officials

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division  
Sarah Hall Ingram, Chief, Appeals

## Definition of Problem

The IRS's Offer in Compromise (OIC) program is no longer being used to any significant extent as a viable collection alternative.<sup>1</sup> Between fiscal year (FY) 2001 and FY 2007, offer receipts declined by 63 percent and the number of offers accepted declined by 70 percent, as shown in Table 1.24.1 below.

TABLE 1.24.1, OIC Receipts and Dispositions by Fiscal Year<sup>2</sup>

Fiscal Year	Receipts	Not Processable Return	Processable Return	Withdrawn/Terminated	Rejected	Accepted	Total Dispositions
FY01	125,390	16,185	27,751	16,654	13,976	38,643	113,209
FY02	124,033	32,897	50,492	13,621	16,952	29,140	143,102
FY03	127,769	30,406	49,079	8,431	27,336	21,570	136,822
FY04	106,025	38,553	32,358	7,859	25,654	19,546	123,970
FY05	74,311	22,713	20,068	7,377	22,105	19,080	91,343
FY06	58,586	16,733	12,350	5,407	14,945	14,734	64,169
FY07	46,270	9,078	10,520	4,557	11,946	11,618	47,719
% Change FY 07 vs. FY 06	-21%	-46%	-15%	-16%	-20%	-21%	-26%
% Change FY 07 vs. FY 01	-63%	-44%	-62%	-73%	-15%	-70%	-58%

In recent years, the IRS has implemented many changes to the OIC program that focused primarily on discouraging unreasonable, inappropriate, or frivolous offers. However, if the IRS were discouraging only unreasonable, inappropriate, or frivolous offers, the decline in submissions would be coupled with an increase in the IRS's acceptance rate. This is not the case. The acceptance rate has fallen from about 34 percent in FY 2001 to approximately 24

<sup>1</sup> Over the past few years, the National Taxpayer Advocate has repeatedly voiced concerns over the rules and procedures that limit the accessibility and use of the OIC program. See, e.g., National Taxpayer Advocate 2001 Annual Report to Congress 52; National Taxpayer Advocate 2003 Annual Report to Congress 99; National Taxpayer Advocate 2004 Annual Report to Congress 311; National Taxpayer Advocate 2005 Annual Report to Congress 270; National Taxpayer Advocate 2006 Annual Report to Congress 62, 83, 141.

<sup>2</sup> SB/SE Collection Activity Report No. 5000-108 (FY 2001-FY 2006); SB/SE Collection Activity Report No. 5000-108 (Oct. 1, 2007).



percent in FY 2007.<sup>3</sup> Thus, it is not surprising that a recent OIC customer satisfaction survey conducted by the IRS confirmed “customer perceptions are that the IRS is pre-disposed to rejecting offers and that the IRS is not realistic in considering taxpayer circumstances.”<sup>4</sup>

The following policies and procedures may discourage taxpayers from submitting good offers:<sup>5</sup>

- New rules that impose fees and require taxpayers to send significant down payments along with their offers;
- The IRS’s practice of returning many offers to taxpayers before the IRS has reached an acceptance or rejection decision, and without appeal rights; and
- Rules related to the resubmission of returned offers.

## Analysis of Problem

### Background

#### *Accepting a reasonable offer is a good deal for the IRS*

When the IRS accepts an OIC based on doubt as to collectibility (DATC), it generally receives an amount equal to all of the taxpayer’s equity in his or her assets plus four or five years worth of future income (net of reasonable living expenses).<sup>6</sup> Further, the IRS can generally close the collection case without waiting for the taxpayer to earn such future income, as it would if it accepted an installment agreement. Moreover, on average, acceptable offers generate more revenue than the IRS would otherwise collect. In FY 2007, accepted offers generated 17 cents for every \$1 owed.<sup>7</sup> By contrast, IRS research indicates the IRS has historically collected only 13 cents for every \$1 owed on debts that are two years old and virtually nothing on debts that have been outstanding for three years or more.<sup>8</sup>

OICs also promote future compliance by requiring, as a condition of the OIC agreement, that the taxpayer timely file returns and pay taxes for the following five years.<sup>9</sup> If the

<sup>3</sup> SB/SE Collection Activity Report No. 5000-108 (Oct. 1, 2007).

<sup>4</sup> IRS, SB/SE Research, *Offer in Compromise (OIC) Customer Satisfaction Survey Research Report -Project FTL0023* (Aug. 2006). The survey went on to add that “improvements may be needed in IRS flexibility, time required and communication of all forms.” *Id.*

<sup>5</sup> As used in this discussion, the term “good offer” means an offer that represents a reasonable good faith attempt by a taxpayer to resolve a tax debt. The taxpayer has followed the instructions provided on the offer form to the best of his or her ability, even if minor defects remain. The offer appears on its face to be acceptable or at least worth perfecting, even if additional information or documentation is required. A good offer also includes any offer that is ultimately accepted by the IRS, even if the IRS required the taxpayer to increase the amount of the offer or provide additional information.

<sup>6</sup> Form 656, *Offer in Compromise* (Feb. 2007). The IRS’s OIC program allows for the compromise of tax liabilities based upon: “doubt as to liability” (DATL), “doubt as to collectibility” (DATC), or furtherance of “effective tax administration” (ETA). IRC § 7122; Treas. Reg. § 301.7122-1, *et. seq.*: Form 656, *Offer in Compromise* (Feb. 2007).

<sup>7</sup> IRS, *Offer in Compromise Program, Executive Summary* (Aug. 13, 2007).

<sup>8</sup> IRS, *Automated Collection System Operating Model Team, Collectibility Curve* (Aug. 5, 2002).

<sup>9</sup> Form 656, *Offer in Compromise* (Feb. 2007). One IRS study found that about 80 percent of taxpayers in its sample of 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 (Sept. 2006).

taxpayer does not fulfill this compliance requirement, the IRS reinstates the full liability (minus any payments that were made during the OIC process).<sup>10</sup> The program can obviously benefit taxpayers because it gives them the “opportunity to place tax debts and their related economic and psychological duress behind them.”<sup>11</sup> Thus, accepting an OIC is a win-win situation for the taxpayer and the government.

Congress and the IRS have long recognized the benefits of accepting good offers. For example, IRS Policy Statement P-5-100 states:

The Service will accept an offer in compromise when it is unlikely that the tax liability can be collected in full and the amount offered reasonably reflects collection potential. The goal of an offer in compromise is to achieve collection of what is potentially collectible at the earliest possible time and at the least cost to the Government.... The ultimate goal is a compromise which is in the best interest of both the taxpayer and the government. Acceptance of an adequate offer in compromise will also result in creating for the taxpayer an expectation of a fresh start toward compliance with all future filing and payment requirements.<sup>12</sup>

Congress also concluded that OICs promote voluntary compliance and directed the IRS “to make it easier for taxpayers to enter into offer-in-compromise agreements” and “do more to educate the taxpaying public about the availability of such agreements.”<sup>13</sup>

However, rather than educating taxpayers and revising procedures to help taxpayers qualify for and submit good offers, the IRS, in an apparent attempt to save resources and reduce processing time, returned many offers (either before or after accepting them for processing) to taxpayers without reaching an acceptance or rejection decision.<sup>14</sup>

### **New rules have made it more difficult and expensive for taxpayers to submit an OIC**

#### *The OIC user fee makes it more difficult for taxpayers to submit good offers*

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.<sup>15</sup> The fee was intended to reimburse the IRS for part of the expense

<sup>10</sup> IRM 5.19.7.3.26 (Dec. 5, 2006).

<sup>11</sup> Stephen Joyce, *Tax Compliance: Value and Effect of New OIC Requirements Under Debate as Effective Date Approaches*, 118 DTR GG-1 (June 20, 2006).

<sup>12</sup> IRS Policy Statement P-5-100, IRM 1.2.1.5.18 (Rev. Jan. 30, 1992); IRM 5.8.1.1.3 (Sept. 1, 2005).

<sup>13</sup> H.R. Conf. Rep. 599, 105th Cong., 2d Sess., 288-289 (1998). The report also noted: “The 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.” *Id.*

<sup>14</sup> See National Taxpayer Advocate 2001 Annual Report to Congress 52 (IRS response).

<sup>15</sup> T.D. 9086, 68 Fed. Reg. 48,785 (Aug. 15, 2003); Treas. Reg. § 300.3. The fee is applied to the offer amount if the offer is accepted on the basis of “effective tax administration” or if collection of an amount greater than the amount offered would create “economic hardship.” *Id.*

of running the OIC program, and to reduce the number of frivolous or unreasonable offers.<sup>16</sup>

However, the fee quickly became an obstacle to the submission of a good OIC. OIC receipts subsequently declined from approximately 128,000 in FY 2003<sup>17</sup> to approximately 106,000 in FY 2004 (or 17 percent) and have decreased in each subsequent year.<sup>18</sup> Moreover, the user fee also multiplied the burden associated with the return of an OIC to a cooperative taxpayer, since the IRS retains the fee if it accepts the offer for initial processing before returning it later.

### Low income waiver ineffective

Low income taxpayers are eligible for an OIC fee waiver if they submit the proper form (Form 656-A) along with the offer application (Form 656, Offer in Compromise). However, the IRS's implementation of the waiver has not prevented the fee from causing a decline in offer submissions from low income taxpayers. The Treasury Inspector General for Tax Administration (TIGTA) found offer submissions from low income taxpayers fell even more than for other taxpayers after the IRS imposed the OIC fee.<sup>19</sup> Moreover, a recent TAS study of accepted offers confirmed that nearly half of the taxpayers below poverty level, who should have been eligible for a waiver of the OIC user fee, did not submit the form required to obtain a waiver.<sup>20</sup> Thus, if the IRS is to achieve the goals of the offer program it must do more to ensure that low income taxpayers know that they are eligible for the waiver.

### *The IRS's administration of the new partial payment requirements makes it more difficult for taxpayers to submit good offers*

The Tax Increase Prevention & Reconciliation Act of 2005 (TIPRA) requires taxpayers who submit offers that will be paid in a lump sum or in five or fewer installments (called "lump-sum" offers) to include a nonrefundable partial payment of 20 percent of the offer amount along with the offer application.<sup>21</sup> TIPRA also requires taxpayers who submit offers pro-

<sup>16</sup> T.D. 9086, 68 Fed. Reg. 48,785, 48,786 (Aug. 15, 2003) (preamble). For further discussion of user fees, see Most Serious Problem, *User Fees: Taxpayer Service For Sale*, *supra*.

<sup>17</sup> Fiscal year 2003 ended on September 30, 2003, about a month before the user fee was implemented on November 1, 2003.

<sup>18</sup> The Treasury Inspector General for Tax Administration (TIGTA) has concluded that the OIC user fee, imposed in November 2003, is responsible for reducing OIC submissions by 28 percent. See Treasury Inspector General for Tax Administration, Ref. No. 2005-30-096, *The Implementation of the Offer in Compromise Application Fee Reduced the Volume of Offers Filed by Taxpayers at All Income Levels* (Jun. 2005).

<sup>19</sup> TIGTA noted that "since poverty level taxpayers are exempt from the \$150 OIC application fee, it was not clear why there was a more significant decline in offer filings by this group of taxpayers... It was possible that initially some poverty-level taxpayers were not aware of this exemption." Treasury Inspector General for Tax Administration, Ref. No. 2006-30-100, *The Offer in Compromise Program Is Beneficial but Needs to Be Used More Efficiently in the Collection of Taxes*, 11 (July 17, 2006).

<sup>20</sup> See *Review of Tax Increase and Prevention Reconciliation Act of 2005 on IRS Offer in Compromise Program*, vol. II, *infra*.

<sup>21</sup> Pub. L. No. 109-222 § 509, 120 Stat. 362 (2006) (effective July 16, 2006 and codified at IRC § 7122(c)(1)). The IRS implemented this legislation by issuing Notice 2006-68, 2006-31 I.R.B. 105 and Memorandum for Directors, Collection Area Offices, Director, Campus Compliance Operations (Brookhaven) and Director, Campus Compliance Operations (Memphis), from Frederick W. Schindler, Director, Collection Policy, *Interim Guidance Memorandum for Internal Revenue Manual 5.8, Offer in Compromise* (July 26, 2007) (hereinafter referenced as an IRM dated July 26, 2007), available at <http://www.irs.gov/pub/foia/ig/sbse/sbse-05-0707-031.pdf>.

posing payments in more than five installments (“periodic payment offers”) to include the first proposed installment along with any offer and to continue to make payments while the IRS is processing the offer.

Congress also gave the IRS considerable latitude in administering the new requirement. When a taxpayer fails to include a partial payment with an offer, the new law provides that the offer “*may* be returned to the taxpayer as unprocessable.” (Emphasis added).<sup>22</sup> The word “*may*” obviously has a different meaning than “*shall*” or “*must*” and gives the IRS the discretion to process such offers.<sup>23</sup> Consistent with the statutory language, Notice 2006-68 provides that the IRS may process offers received without a partial payment if the IRS “determines that continued processing of the offer is in the best interest of the government.”<sup>24</sup> The National Taxpayer Advocate as well as external stakeholders urged the IRS to ensure that new requirements in TIPRA would not further discourage taxpayers from making good offers.<sup>25</sup>

The IRS responded by adopting procedures that allow IRS employees to continue to process a lump-sum offer that fails to include the full partial payment, so long as it includes some partial payment.<sup>26</sup> Moreover, the IRS may not require the full TIPRA payment if the “taxpayer gives an explanation supporting special circumstances as a reason the funds were not available.”<sup>27</sup>

In addition, taxpayers whose incomes are below 250 percent of the federal poverty threshold are exempt from both the OIC user fee and the partial payment requirements.<sup>28</sup> Even so, the National Taxpayer Advocate, the Government Accountability Office (GAO), and tax practitioners have all expressed concern that the partial payment requirement could reduce the accessibility of the OIC program to low income taxpayers and others who are already

<sup>22</sup> IRC § 7122(d)(3)(C).

<sup>23</sup> The version of TIPRA that passed the Senate (S. 2020) provided an exclusive remedy for a taxpayer’s failure to include a TIPRA payment. It said “any offer-in-compromise which does not meet the requirements of subsection (c) *shall* be returned to the taxpayer as unprocessable.” (Emphasis added). If that language had been retained, the IRS would not have been able to either accept or reject such offers. The conference report confirms that the conferees changed the language to “*may*,” giving the IRS discretion not to return such offers. H.R. Conf. Rept. 109-455, 234-235. It would make little sense for the conferees to change a mandatory requirement that the IRS return offers not accompanied by the TIPRA payment to a discretionary requirement simply to give the IRS the option to reject these offers instead of returning them. The Government Accountability Office (GAO) issued a report just before the bill went to conference, which highlighted how often the IRS returns offers rather than rejecting them and raising concerns about accessibility of the OIC program. Government Accountability Office, GAO-06-525, *IRS Offers in Compromise, Performance Has Been Mixed: Better Management Information and Simplification Could Improve the Program* (Apr. 2006).

<sup>24</sup> Notice 2006-68, 2006-31 I.R.B. 105.

<sup>25</sup> See, e.g., National Taxpayer Advocate 2006 Annual Report to Congress 62, 83, 141, 507; National Taxpayer Advocate Fiscal Year 2008 Objectives Report to Congress xvii (June 30, 2007). ABA Tax Section, *Comments in Response to Notice 2006-08 Regarding Definition of “Low Income” and Waiver Authority under Section 7122(c)(2)(C)* (Oct. 16, 2006), available at <http://abanet.org/tax/pubpolicy/2006/101606notice2006-68.pdf>. (noting, for example, that “the \$150 processing fee may already deter people from filing offers”, and that the new requirements “may be too much of a burden” for many taxpayers).

<sup>26</sup> IRM 5.8.3.13(1) (July 26, 2007).

<sup>27</sup> IRM 5.8.3.17(7) (July 26, 2007).

<sup>28</sup> Form 656, *Offer in Compromise* (Feb. 2007). The National Taxpayer Advocate commends the IRS for recently increasing the low income threshold from 100 percent to 250 percent of the federal poverty level, in conformity with the IRC § 7526 eligibility requirements for Low Income Taxpayer Clinic (LITC) assistance. See Form 656-A, *Income Certification for Offer in Compromise Application Fee and Payment* (Feb. 2007).

experiencing financial difficulties.<sup>29</sup> Moreover, in FY 2007 the IRS still returned 7,498 offers (or 16 percent) to taxpayers unprocessed because they failed to include the partial payment.<sup>30</sup>

### Difficulty funding partial payments

A recent TAS study (published in Volume 2 of this report) found that in about 70 percent of the offers accepted by the IRS before TIPRA was implemented, the 20 percent partial payment was not available from liquid assets.<sup>31</sup> In other words, most taxpayers who submitted good offers that the IRS accepted would have had more difficulty submitting those same offers if the partial payment rules had been in place. Three examples best illustrate the difficulty taxpayers may face in making the partial payments before an offer is accepted:

- *Friends and family.* Some taxpayers are able to obtain funds from relatives or friends who are willing to help them but are under no legal obligation to do so.<sup>32</sup>
- *Retirement Assets.* Some taxpayers have IRAs or other retirement assets that they can access but that the IRS otherwise would not levy or seize.<sup>33</sup> However, tapping into an IRA subjects the funds to federal and state income tax at ordinary rates plus the ten percent additional tax on early withdrawals.
- *Home equity.* Lenders often will not loan the required 20 percent to a debtor unless the IRS agrees to compromise the debt.

Further, TAS is worried that the partial payment requirements may encourage taxpayers to submit “low ball” lump sum offers rather than realistic offers based on solid financial analysis. As noted above, the IRS does not return lump-sum offers that do not include the correct partial payment amount as long as the taxpayer submits some partial payment.<sup>34</sup> However, the IRS has not widely publicized this option or shared alternative solutions such as a periodic payment offer with minimal initial payments and a balloon payment to be paid upon OIC acceptance. Thus, taxpayer confusion could help explain why TIPRA

<sup>29</sup> See, e.g., National Taxpayer Advocate 2006 Annual Report to Congress 62, 83, 141, 507; National Taxpayer Advocate’s Report to Congress Fiscal Year 2008 Objectives xvii (June 30, 2007); Government Accountability Office, GAO-06-525, *IRS Offers in Compromise, Performance Has Been Mixed: Better Management Information and Simplification Could Improve the Program*, 38-39 (Apr. 2006); ABA Tax Section, *Comments in Response to Notice 2006-08 Regarding Definition of “Low Income” and Waiver Authority under Section 7122(c)(2)(C)* (Oct. 16, 2006). Moreover, the IRS needs to improve implementation of and communications about the low income waiver, as discussed above in connection with the OIC fee, since the same form and criteria are used for waiving the OIC fee and the partial payment requirement.

<sup>30</sup> SB/SE response to TAS research request (July 13, 2007).

<sup>31</sup> See *Review of Tax Increase and Prevention Reconciliation Act of 2005 on IRS Offer in Compromise Program*, vol. II, *infra*. For purposes of the study, “liquid assets” included assets that could be liquidated and used for the TIPRA payment (e.g., cash, bank accounts, certificates of deposit, stock and securities) without incurring significant costs. For example, individual retirement accounts were not considered “liquid” because a ten percent additional tax on early distributions applies to early withdrawals.

<sup>32</sup> See *Review of Tax Increase and Prevention Reconciliation Act of 2005 on IRS Offer in Compromise Program*, vol. II, *infra*. TAS’s study found that 56 percent of all accepted offers are funded by friends and family. *Id.*

<sup>33</sup> The IRS generally will not levy on a qualified plan unless the taxpayer’s behavior has been “flagrant.” See IRM 5.11.6.2 (Mar. 15, 2005). If it does levy on such payments, no early withdrawal penalty applies. IRC § 72(t)(2)(A)(vii).

<sup>34</sup> IRM 5.8.3.4.1 (July 28, 2006).

appears to be discouraging taxpayers from submitting all offers rather than just unreasonable or inappropriate ones.

### **OIC returns discourage taxpayers from submitting good offers**

In FY 2007, the IRS returned over 41 percent of all OICs either before (19 percent) or after (22 percent) initially accepting them for investigation.<sup>35</sup> For taxpayers, the likelihood that the IRS will return an OIC without completing its investigation is particularly discouraging because any partial payments are nonrefundable (regardless of whether the IRS returns the offer before or after it is accepted for processing) and the determination to return these offers cannot be appealed.<sup>36</sup> As a result, the potential financial impact of the IRS's decision to return an OIC has become much greater.

If a taxpayer wants the IRS to consider an offer that was returned, he or she must often submit another OIC. Interestingly, the GAO determined that 40 percent of the IRS's OIC inventory in FY 2005 was made up of repeat offers, many of which the IRS had previously returned.<sup>37</sup> The offers that taxpayers have to resubmit are just as likely to be good offers as those that taxpayers submit only once. A prior IRS study concluded the IRS ultimately accepts about 24 percent of resubmitted offers, with 53 percent of these taxpayers increasing their offer amounts.<sup>38</sup> However, given the new partial payment requirement, many taxpayers may no longer be able to afford to resubmit returned offers because the IRS does not refund the partial payments or allow the taxpayer to apply the payment to a resubmitted OIC when it returns the offer.<sup>39</sup>

### **The risks associated with resubmitting returned offers may discourage good offer submissions or resubmissions**

If the IRS returns an offer and the taxpayer resubmits it, the resubmitted OIC could also be construed by the IRS as "solely to delay collection" and returned without further investigation.<sup>40</sup> In such a case, the taxpayer would lose any partial payment and possibly any user fee included with the offer. TAS has raised concerns on many occasions over the ambiguous definition of "solely to delay collection" as it relates to IRS payment alternatives and has pointed out that the examples cited in IRS guidance only add confusion to the process.<sup>41</sup>

<sup>35</sup> SB/SE Collection Activity Report No. 5000-108 (Oct. 1, 2007).

<sup>36</sup> See, e.g., Notice 2006-68, 2006-31 I.R.B. 105.

<sup>37</sup> Government Accountability Office, GAO-06-525, *IRS Offers in Compromise, Performance Has Been Mixed; Better Management Information and Simplification Could Improve the Program* 13-14 (Apr. 2006).

<sup>38</sup> 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*, 4-5 (Sept. 2004).

<sup>39</sup> Both the National Taxpayer Advocate and the American Bar Association have urged the IRS to give taxpayers credit for TIPRA payments associated with prior offers returned, rejected or withdrawn when another offer is resubmitted within a reasonable period of time thereafter. See ABA Tax Section, *Comments in Response to Notice 2006-08 Regarding Definition of "Low Income" and Waiver Authority under Section 7122(c)(2)(C)* (Oct. 16, 2006). But, as discussed above, the IRS could reach the same result without legislation.

<sup>40</sup> IRM 5.8.3.19.1(1) (Sept. 1, 2005).

<sup>41</sup> IRM 5.8.3.19 (Sept. 1, 2005).



Further, the IRS recently received statutory authority under IRC § 6702(b) to impose a \$5,000 penalty for “frivolous” OIC submissions. Practitioners who assist taxpayers in resubmitting offers may fear that the IRS would seek such a penalty or refer them to be disciplined by the Office of Professional Responsibility (OPR), as such offers could be possibly be deemed to be “frivolous” or to “unreasonably delay” the prompt resolution of the matter in violation of Circular 230.<sup>42</sup> Given the IRS’s practice of routinely returning offers, it should reduce such concerns by issuing guidance to clarify when an offer resubmission will not be treated as “solely to delay collection,” “frivolous,” or an attempt to “unreasonably delay” collection.

### **The inability of a taxpayer to appeal the IRS’s decision to return an OIC may discourage good offer submissions**

While the IRS will reconsider its decision to return an OIC in certain limited circumstances, the taxpayer cannot appeal the OIC return decision to the Appeals function.<sup>43</sup> Since so much of the IRS’s determination to return an offer involves the exercise of discretion and judgment, the National Taxpayer Advocate proposed legislation in her 2006 Annual Report to Congress that would provide taxpayers with applicable rights before or after accepting an OIC for processing.<sup>44</sup> Such appeal rights would give taxpayers (and the third parties who fund their offers) more confidence that if they play by the rules and submit an offer in good faith, the IRS is unlikely to return the offer unprocessed and retain any partial payments. The IRS could take similar steps on its own to improve accessibility of the OIC program by subjecting OIC returns to an appeals process without legislation. As discussed above, it could also use its discretion not to return offers that contain insufficient partial payment in cases where taxpayers could not make the partial payment out of liquid assets or without triggering an economic hardship.

### **IRS Comments**

Offers in compromise continue to be an important alternative for taxpayers who are not able to pay in full. The IRS continues to use this program to address and resolve delinquent accounts from taxpayers that qualify. The policies and procedures that the IRS has put in place ensure that taxpayers that qualify have accessibility to the program. We have made continuous improvement to our procedures to ensure that taxpayers who qualify for an OIC receive a decision on their OIC in a timely manner. The offer program is not a viable resolution for all taxpayers and we have adopted a number of communication strategies to educate the public about the offer program. We believe the policies and procedures

<sup>42</sup> See Circular 230 § 10.23. In FY 2006, OPR received a total of 505 referrals from IRS employees. Senior Counsel, OPR, Response to TAS information request (June 19, 2007). In 30 of these, the employee was raising concerns about practitioner due diligence and/or delay in connection with an offer. Senior Counsel, OPR, response to TAS information request (Sept. 27, 2007). In FY 2007, OPR had received 20 such OIC-related referrals. *Id.*

<sup>43</sup> See Treas. Reg. § 301.7122-1(f)(5)(ii) (noting that “return of the offer does not constitute a rejection of the offer for purposes of this provision and does not entitle the taxpayer to appeal the matter to Appeals...”).

<sup>44</sup> See National Taxpayer Advocate 2006 Annual Report to Congress 507-519 (Key Legislative Recommendation: *Improve Offer in Compromise Accessibility*). The IRS could use the existing Collection Appeals Process, which allows it to review appeals in just five days.



we have put in place benefit both the taxpayer and the government and ensure the proper use of the OIC program.

The IRS believes that the long-term success of the compromise program is best served by maximizing the number of cases in which the IRS is able to complete the investigation and make a decision to accept or reject the offer on its merits. To that end, we have repeatedly revised our procedures to maximize the number of OIC cases that are actually investigated. For example, in FY 2007, we made changes to our processability criteria that made it easier for a taxpayer to file a processable offer. As a result, our percentage of “Not Processable” returns decreased from 26 percent in FY 2006 to 19 percent in FY 2007 and has decreased 44 percent since FY 2001. Over 40 percent of cases that progress to the point that an accept or reject decision can be made are accepted.

That said, the IRS does agree that the success or failure of the program should be measured by statistics on case disposition or yield. Our goal is to accept as many offers in compromise as there are taxpayers that qualify for the program. We agree that acceptance of an OIC benefits both the taxpayer and the government. Even with the implementation of the application fee and the down payment requirements imposed by TIPRA, our acceptance rate has increased every year since FY 2004.

The user fee was implemented in November 2003, to help offset the cost of the OIC program and to reduce the number of offers submitted without merit. The IRS has recently taken steps to minimize the impact of the user fee on taxpayers, most notably by broadening the definition of low-income so that more taxpayers will qualify for a waiver of the fee. We do not believe the user fee is the sole reason for the decline in offer receipts. Offer receipts have been declining since FY 2001, prior to the implementation of the user fee. Although OIC receipts have been declining since FY 2001, the rate of decline has slowed even after implementation of new policies and procedures to implement the down payment requirement mandated by TIPRA.

One factor that we believe has led to the decline in OIC receipts is the many outreach efforts the IRS have conducted over the past few years to help educate taxpayers and taxpayer representatives about OICs. These outreach efforts have led to a better understanding of who may qualify for an OIC and have therefore been a contributing factor to the declining receipt of OICs. In addition, we recently released a revised Form 656, Offer in Compromise, which was fashioned to assist taxpayers in making an informed decision about whether they are a candidate for an offer in compromise.

Recent receipts show that the low income waiver is effective and is actively being taken advantage of by taxpayers who qualify. In response to stakeholder concerns, the IRS revised the low income guidelines to include all taxpayers with incomes of 250 percent of the poverty level and below. Low income taxpayers who complete the Form 656-A, Income Certification for Offer in Compromise Application Fee, and qualify for the waiver are exempt from the application fee and from making any TIPRA payments while the offer is

under consideration. The revised low income guidelines have greatly expanded the audience that is eligible for the waiver. The new guidelines became effective with the publishing of the Form 656, Offer in Compromise, in February 2007. As of September 2007, the percentage of processable offer receipts with a Form 656-A, Income Certification for Offer in Compromise Application Fee, has increased to 17.8 percent from 6.8 percent in FY 2006. We attribute this increase in receipts to not only a larger eligible population but a number of communication efforts including clear instructions in the revised Form 656, Offer in Compromise, information about the waiver on [www.irs.gov](http://www.irs.gov), and outreach activities that the IRS has completed such as Tax Forums and OIC external stakeholder presentations.

The TIPRA legislation became effective for all OICs received after July 16, 2006. The revised Form 656, Offer in Compromise, that includes the new TIPRA OIC guidelines and explanation of the new payments terms was published in February 2007. The IRS recognizes that the non-refundable payments required by the TIPRA legislation may cause some taxpayers to be hesitant to submit an offer in compromise; especially those taxpayers whose only means to fund their offers is from gifts or payments from friends or family. The IRS is working with the Office of Chief Counsel and representatives of TAS to implement the legislation in a manner that makes reasonable exceptions to the payment requirement that are consistent with the statute.

The return procedures that are currently in the IRM are necessary to ensure that valuable resources are not expended working cases in which taxpayers do not respond to requests for information or are not in compliance with current filing or deposit requirements. The IRS has implemented policies and procedures to ensure that cases are returned only when warranted. We also include a review of returned offers in our operational reviews of the program areas and have incorporated a section in the IRM that allows for return reconsideration. In addition, all returns require the group manager's concurrence. While FY 2007 results show that 41 percent of offers were either returned as processable or not processable, a recent TIGTA review of returned offers showed that the returns were appropriate. In addition, from October 1, 2006 through July 31, 2007, 52 percent of all processable returns were returned because the taxpayer did not give us the information needed to investigate their case.

The majority of processable returns are made because the taxpayer fails to submit the information that is necessary to properly evaluate the OIC in a timely manner or because the taxpayer is not currently in compliance with filing or payment requirements. It will benefit neither the taxpayer nor the IRS to send a case to Appeals that has not progressed to the point that a resolution can be reached. We believe that the currently established procedures to reconsider such decisions are adequate. However, as part of a recently established working group that includes representatives of TAS, the IRS has committed to reexamining return procedures to ensure that adequate safeguards are in place (along with other Collection issues impacting the offer program).

The OIC solely to delay procedures outlined in the IRM are intended to be used with discretion. In FY 2007, offers returned as solely to delay collection accounted for only three percent of all return dispositions, and one percent of total offer case dispositions. Offers returned for this reason require the manager's concurrence and signature. The taxpayer has the right to speak with the manager about the decision to return the offer as solely to delay collection and IRM 5.8.7 allows for return reconsideration when appropriate. Examples of situations where returning an offer as solely to delay collection is appropriate are included in IRM 5.8.3.19 and available to IRS employees for use as guidance when making a determination to return a case as solely to delay collection. The IRS appreciates the National Taxpayer Advocate's concern about the examples provided in IRM 5.8.3.19 and most recently, we revised the language in this section to provide more clarity. The revised section is currently in clearance and expected to be available shortly. We invite the National Taxpayer Advocate to bring to our attention situations in which the application of this procedure may be misused.

With respect to the National Taxpayer Advocate's concern that resubmitted offers will be deemed frivolous under IRC § 6702(b), the IRS is currently working with the Office of Chief Counsel to determine if there are any situations in which an OIC would be considered frivolous or reflect the desire to delay or impede the administration of federal tax law. Accordingly, we have not yet issued guidance or procedures for imposing this penalty. We agree that the potential application of this penalty within the offer program is likely to be very rare.

The IRS appreciates the input that the National Taxpayer Advocate continues to provide regarding the OIC program. We will continue to use this valuable feedback to improve our policies and procedures. The offer program is a valuable collection alternative for those taxpayers that qualify and we are continuing our education and outreach efforts to further educate the public about the offer program and eligibility requirements.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS acknowledges "offers in compromise continue to be an important alternative for taxpayers who are not able to pay in full." We also commend the IRS for its recent revision of Form 656 which should help to better educate taxpayers about the offer program and eligibility requirements. However, the National Taxpayer Advocate is concerned that in spite of declining OIC receipts, growing customer dissatisfaction and countless governmental reports (*e.g.*, TAS, GAO, and TIGTA), the IRS's response otherwise reflects a reluctance to use offers as a viable collection tool. We agree that an offer is not a viable solution for *all* taxpayers but we still question whether the IRS has properly assessed the performance of its OIC program to determine why it is a viable solution for *so few* taxpayers. While not *always* appropriate, as Congress

noted, offers are an appropriate option in *many* cases, and in those cases accepting an offer is a “win-win” situation for the IRS and the taxpayer alike.

The National Taxpayer Advocate agrees that the long-term success of the OIC program is best served by maximizing the number of cases in which the IRS is able to complete the investigation and make a decision to accept or reject the offer on its merits. However, for the IRS is to achieve its policy goals and reap the benefits of a successful OIC program, it must first minimize the extent to which policies intended to deter taxpayers from submitting incomplete or unrealistic offers do not also discourage taxpayers from submitting good ones. We applaud the IRS for its recent relaxation of the processable criteria, which has in fact lessened the number of offers returned as not processable.

However, the key to success of the offer program is to find those who could most benefit from the OIC process and then take the proper steps to facilitate a resolution that is in the best interest of the taxpayer and the government. The IRS apparently believes it has done so by noting that its acceptance *rate* has increased every year since FY 2004. However, the *number* of offers accepted by the IRS has declined every year since FY 2001. As noted above, between FY 2001 and FY 2007, offer receipts declined by 63 percent while the number of offers accepted declined by 70 percent. Thus, the decline in offers accepted has actually exceeded the decline in offers received. The IRS implicitly suggests that recent policy and procedural changes such as those resulting from TIPRA and the OIC user fee do not discourage taxpayers from submitting offers when it notes that the rate of decline in OIC receipts has slowed, but this analysis fails to consider the fact that given the increasingly small number of OIC receipts it would be difficult to maintain such a steep rate of decline.

The National Taxpayer Advocate recognizes that the IRS has initiated various outreach efforts over the past few years that have led to an increased awareness of the OIC program. Moreover, we agree that the revised Form 656 is an improvement from prior versions and does offer helpful information regarding the completion of an OIC. However, the external presentations and communications that TAS has observed still lack the specificity and examples needed to help a taxpayer truly understand whether the OIC program is the right option. Moreover, if the outreach efforts are as effective as the IRS says they are, should we not see an increase in offer receipts and acceptances?

The National Taxpayer Advocate commends the IRS for the revision of its low income guidelines to include (and exempt from the OIC user fee) all taxpayers with incomes at or below 250 percent of the federal poverty levels. It should come as no surprise that the percentage of processable OIC receipts with the applicable Form 656-A waiver has increased in FY 2007 since the IRS increased the number of taxpayers eligible for the waiver. Yet, the recent TAS study of accepted offers found nearly half of the taxpayers below the poverty level (and who should have been eligible for the waiver) did not submit the form required to obtain a waiver. Thus, the IRS should do more to ensure every eligible taxpayer obtains a waiver.

We are pleased that the IRS recognizes that the non-refundable payments required by TIPRA legislation may cause some taxpayers to be hesitant to submit an OIC, especially those taxpayers whose only means to fund their offers is from gifts or payments from friends or family. We look forward to our continued participation with the IRS and the Office of Chief Counsel to develop more suitable policies and procedures to make reasonable exceptions to the payment requirement that are consistent with the statute.

However, the IRS has been reluctant thus far to create any type of appeals process for returned offers. Although the IRS states that over half of all processable returns were returned because the taxpayer did not provide the information needed to investigate their case, an appeal of these returns could assess, “Did the IRS really need this information to process the offer?” or “Was the information actually included but not recognized by the IRS?” While the IRS suggests that a TIGTA review that showed that the IRS’s decision to return offers was appropriate, we wonder if this is the same review in which TIGTA determined that 15 percent of the OICs returned after acceptance for processing were returned in error.<sup>45</sup> Thus, if the IRS is to err, it should err on the side of caution and allow the Office of Appeals to impartially and independently review the IRS’s decisions. Appeal rights are especially important in these situations because the IRS retains the taxpayer’s 20 percent OIC down payment. We are nevertheless encouraged by the IRS’s willingness to reconsider its OIC return procedures as part of the recently established working group that includes representatives from TAS.

The National Taxpayer Advocate is pleased that the IRS recognizes the need for discretion when returning OICs under the authority of solely to delay collection. The fact that the IRS has returned very few OICs for this reason is encouraging. We are also appreciative of the IRS’s receptiveness to TAS’s recommendation to provide better examples of solely to delay situations in the IRM. We continue to emphasize that these examples should be as realistic and specific as possible so that it is not left up to the employee’s own interpretation. We are also concerned that these practices might also be discouraging taxpayers from resubmitting offers that the IRS has returned. To address this concern, IRS guidance should include several realistic examples of offer resubmissions that are *not* deemed solely to delay collection.

We also appreciate the IRS’s candor in stating that it is currently working with the Office of Chief Counsel to determine situations that would be considered frivolous or reflect the desire to delay or impede the administration of federal tax law under IRC § 6702(b). We agree that the imposition of such penalty should be rare and should not adversely affect those individuals who are voluntarily attempting to resolve their tax obligations through a legitimate collection alternative such as an OIC.

<sup>45</sup> See Treasury Inspector General for Tax Administration, Ref. No. 2003-30-182, *Continued Progress Is Needed to Improve the Centralized Offer in Compromise Program 1* (Sept. 2003).

In closing, the IRS notes that the user fee, and presumably TIPRA, was meant to discourage meritless offers. If it were successful at that, we would still be seeing at least the same number of acceptable offers as in 2001. But we aren't. So, the sum of all these procedures, plus taxpayer and stakeholder belief that the IRS doesn't want offers, all combines and results in the number of accepted taxpayer offers declining by 70 percent since 2001. In short, the IRS must work hard to restore faith in its administration of the OIC program.

## Recommendations

1. Provide taxpayers with the right to appeal to the IRS Appeals function the IRS's decision to return an OIC before or after accepting it for processing. The IRS could use the existing Collection Appeals Process, which allows it to review appeals in just five days. The IRS should also conduct a comprehensive review of OICs that were returned as both not processable and processable to ensure employees are in fact making the correct decision.
2. Give taxpayers credit for TIPRA payments associated with prior offers returned, rejected, or withdrawn within the preceding 24 month period on the basis that the new offer should really be regarded as part of the same debt resolution process.
3. Revitalize its OIC outreach efforts to taxpayers and practitioners and to better assist them with the submission of "good" or reasonable and appropriate offers and clearly state that OICs are an acceptable collection alternative. Additionally, the IRS should ensure that low income taxpayers are made more fully aware that they are exempt from the \$150 OIC user fee and TIPRA payment requirements. We strongly recommend that the IRS partner with TAS and the Low Income Taxpayer Clinics, in particular, to help convey this important guidance. The IRS should also conduct a study to determine why taxpayers who qualify for the waiver do not request it.
4. Ensure that OIC training is a mandatory topic in FY 2008 for all Collection personnel responsible for taxpayer contact (*e.g.*, Revenue Officers and ACS employees) to heighten employee awareness of OICs being a "win-win" situation for taxpayers and the government, given the appropriate set of circumstances, and partner with TAS to develop such training.
5. Issue guidance that includes several realistic examples of offer resubmissions that are not deemed solely to delay collection.

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## Inadequate Training and Communication Regarding Effective Tax Administration Offers

### Responsible Official

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division

### Definition of Problem

Although the IRS has the ability to accept an offer to compromise a tax debt on the basis of “effective tax administration” (ETA), it has done very little to educate the public or its employees about how or when it will use this authority. As a result, eligible taxpayers may not be applying for offers based on ETA and IRS employees may not recognize when these offers are appropriate.

### Analysis of Problem

#### Background

Prior to 1998, the IRS considered offers to compromise tax liabilities based upon “doubt as to collectibility” or “doubt as to liability.”<sup>1</sup> In 1998, Congress clarified that the IRS could also accept an offer in compromise (OIC) based on ETA, which the IRS interprets as allowing it to compromise on the basis of “economic hardship” or “equity and/or public policy” (called “non-hardship” ETA offers).<sup>2</sup> The conference report urged the IRS to “do more to educate the taxpaying public about the availability of such agreements.”<sup>3</sup>

The IRS initially responded by publishing regulations and an Internal Revenue Manual (IRM) to provide guidance on processing ETA offers, and by setting up a specialized group of Collection employees to work all non-hardship ETA offers.<sup>4</sup> In recent years, however, the IRS has done nothing to “educate the taxpaying public about the availability” of ETA

<sup>1</sup> For a more detailed discussion of the OIC program and IRS collection strategy, see Most Serious Problem: *Offer in Compromise*, *supra*; Status Update: *IRS Collection Strategy*, *infra*.

<sup>2</sup> IRS Restructuring and Reform Act of 1998, Pub. L., No. 105-206 (1998); H.R. Conf. Rep. 599, 105th Cong., 2d Sess., 289 (1998); Treas. Reg. § 301.7122-1(b)(3). “Economic hardship” occurs when an individual taxpayer is unable to pay reasonable basic living expenses. See Treas. Reg. § 301.6343-1.

<sup>3</sup> H.R. Conf. Rep. 599, 105th Cong., 2d Sess., 289 (1998) (stating that “[T]he 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*”). (Emphasis added).

<sup>4</sup> See T.D. 9007, 67 Fed. Reg. 48,025, 48,026 (July 23, 2002) (preamble); IRM 5.8.11 (Feb. 4, 2000).



offers.<sup>5</sup> Thus, it is not surprising that the number of ETA offers (both hardship and non-hardship) submitted to the IRS has decreased by approximately 60 percent over the last three years.<sup>6</sup>

### Non-Hardship ETA Offers

Over the last three years, the National Taxpayer Advocate worked very closely with the IRS to develop detailed, published guidance to address when it is appropriate for the IRS to use its ETA authority to compromise on the basis of equity or public policy (*i.e.*, when to accept “non-hardship” ETA offers). In November 2006, the IRS released guidance in the form of an “interim guidance memo.”<sup>7</sup> While this memo was initially available to IRS employees on an internal IRS website and to the public on the external IRS website, at one point this year the IRS inadvertently removed the non-hardship ETA offer memo from the internal IRS website where Collection employees expect to find interim guidance on offers.<sup>8</sup>

We are pleased that as of September 2007, Collection was working to incorporate this guidance into its IRM. However, additional communication, outreach, guidance, and training are still needed to ensure employees and taxpayers alike are aware of this important and viable provision. As of this writing, the IRS has not clarified its guidance or even publicly responded to calls from legislators to use its existing ETA authority to address potentially inequitable or devastating situations encountered by many taxpayers.<sup>9</sup> Thus, taxpayers facing such situations may be confused about whether or not they are eligible for ETA offers and whether or not the IRS is abusing its discretion if it refuses to compromise their cases.

Without additional outreach and access to clear guidance, taxpayers will not know when it is worthwhile to submit non-hardship ETA offers, nor will IRS employees be able to identify cases they should forward to the specialized group of examiners who work on ETA offers. As a result, some taxpayers who would be eligible will not know about the program. Even if they do find out about it, the IRS may not accept their offers because employees may fail to realize that they should forward the offers to the specialists who are supposed

<sup>5</sup> In response to TAS’s request for the IRS to identify “all external communications related to ETA offers” during FY 2006 and FY 2007, the IRS did not identify any. SB/SE response to TAS research request (Oct. 10, 2007). In the 2004 Annual Report to Congress, the National Taxpayer Advocate raised concerns that the IRS was not using its ETA authority to the extent that Congress intended. National Taxpayer Advocate 2004 Annual Report to Congress 311. The National Taxpayer Advocate also made a key legislative recommendation urging Congress to give the IRS more specific direction to compromise tax liabilities in cases where it is inequitable to collect them. *Id.* at 433-450.

<sup>6</sup> The number of OICs accepted on the basis of effective tax administration has also declined by nearly 50 percent from FY 2005 to FY 2007. SB/SE response to TAS research request (Nov. 2, 2007).

<sup>7</sup> SB/SE, Memorandum For Directors, Collection Area Offices, From, Director, Collection, Control No. SBSE-05-1106-047, *Guidance Regarding “Non-hardship” Effective Tax Administration Offers in Compromise* (Nov. 30, 2006).

<sup>8</sup> The IRS quickly replaced the memo on its internal website when TAS brought the omission to its attention.

<sup>9</sup> See, e.g., Meg Shreve, *Grassley Asks Treasury, IRS To Help Homeowners Struggling With Tax Bills*, 2007 TNT 180-1, (Sept. 14, 2007) (urging the administration to “take ‘immediate steps’ to encourage homeowners facing large tax bills because of home loan debt forgiveness on a primary residence to send, ‘and have the [IRS] accept,’ offers in compromise that would ‘either eliminate or reduce the taxes’ that those homeowners owe”); Sen. Chuck Grassley, *Grassley Addresses Disclosure, E-Filing At Hearing On Tax Return Preparation*, 2006 TNT 65-31 (Apr. 5, 2006) (stating “my patience is wearing thin on the issue of Offers in Compromise and Effective Tax Administration.... It is important to many of my constituents hit by the Incentive Stock Option AMT.... I see no reason why the IRS cannot put a pilot program together in this area and see what the reaction is from practitioners and taxpayers – rather than doing nothing for fear of the unknown.”).

to process them. Not surprisingly, the Collection and Appeals functions accepted a combined total of only 55 non-hardship ETA offers in Fiscal Year (FY) 2006, and even fewer in FY 2007 (a combined total of 49).<sup>10</sup>

### Hardship ETA Offers

With the exception of the IRM used by offer specialists,<sup>11</sup> guidance addressing ETA offers based on hardship is conspicuously absent from published policies and procedures governing the IRS Collection program, *e.g.*, guidance used by revenue officers (IRS Collection employees who work in the field) and Automated Collection Site (ACS) contact employees (Collection employees who work in centralized sites, other than the sites devoted specifically to offers).<sup>12</sup> Moreover, the training modules for these employees include little if any discussion of ETA offers.<sup>13</sup> Consequently, although Collection employees are required to consider all collection alternatives prior to initiating enforced collection actions such as seizures and foreclosures, the majority of these employees have little or no direction regarding the proper consideration and use of the ETA offer.<sup>14</sup> Accordingly, in FY 2007, TAS has encountered a number of situations where the IRS has pursued collection on the equity in taxpayers' homes, with absolutely no consideration of whether the ETA offer would be a viable collection option.

### Summary

Although legislative history and the National Taxpayer Advocate have urged the IRS to educate the public and IRS employees about the availability of ETA offers, the IRS has not done so.<sup>15</sup> If only to fulfill its duty to administer the laws fairly and consistently, the IRS must ensure that employees and taxpayers alike know not only about collection tools, such as, levies, seizures or suits to foreclose, but also offers in compromise, including ETA offers, and understand when these options are appropriate.

### IRS Comments

Offers in compromise based on the promotion of effective tax administration ("ETA offers") play a very important role in the OIC program. The IRS agrees that in order to maximize the effectiveness of this authority, its existence and parameters must be communicated to

<sup>10</sup> SB/SE response to TAS research request (Nov. 2, 2007).

<sup>11</sup> IRM 5.8.11 (Sept. 1, 2005).

<sup>12</sup> Our research of the applicable collection IRMs only turned up references to ETA offers in IRM 5.8, *Offer in Compromise*, and a brief vague reference in IRM 5.19.7.3, *Campus Collection Programs*. The other IRMs commonly used by revenue officer and ACS employees (IRM 5.1 through 5.20) contain no other references to ETA offers.

<sup>13</sup> Our research of the applicable collection training modules only turned up brief references to ETA offers in the Basic Revenue Officer curriculum. The other training modules commonly presented to revenue officer and ACS employees contain no other references to ETA offers.

<sup>14</sup> See IRM 5.10.1.3.2 (Dec. 13, 2005); IRM 5.17.4.8.2 (Sept. 20, 2000).

<sup>15</sup> National Taxpayer Advocate 2004 Annual Report to Congress 433-450.

both taxpayers and IRS employees. To that end, we have taken numerous steps to train IRS employees and educate the public about this program.

The IRS maintains a strong commitment to educate the public and practitioners about ETA offers. We have incorporated information about ETA offers into our Tax Phone Forums and external OIC stakeholder presentations. In February 2007, we revised the language in Form 656, Offer in Compromise, to help clarify the definition of an ETA offer, when an ETA offer is appropriate, and outline the documentation a taxpayer should include with an ETA offer. ETA offers are also discussed in the OIC section of IRS.gov. In addition, the group manager of the ETA centralized group has addressed various CPA and enrolled agent groups over the last three years on the subject of ETA offers.

Internally, the IRS has provided training to all OIC program employees. In FY 2000, we began incorporating ETA training and communication in all Collection revenue officer training. In 2003, we developed an ETA training course that was provided to all OIC specialists as part of Continued Professional Education (CPE). In FY 2004, we centralized the ETA Non-Economic Hardship (NEH) group in Austin, Texas in order to provide expertise and consistency in the application of the ETA NEH program. During FY 2006, the ETA NEH manager and staff conducted training and education to offer groups across the nation via teleconferences. Campus OIC (COIC) employees and field offer specialists again received training on ETA offers during this year's CPE.

The IRS agrees that all collection contact employees must be aware that ETA offers are an alternative if cases are to be identified and routed for consideration. In November 2006, we issued an interim guidance memorandum titled "Guidance Regarding 'Non-hardship' Effective Tax Administration Offers in Compromise." The memorandum provided specific and detailed guidance on the criteria for a non-economic hardship OIC, specific examples of compelling public policy or equity determinations and how to determine an acceptable offer amount. Although the ETA program is administered within the compromise program, the guidance was issued to all Collection, Campus Compliance, Counsel and Appeals employees so that all employees are equipped to identify cases. Even though the memorandum was at one point inadvertently removed from an intranet site dedicated to the compromise program, the memorandum has been continuously available to all IRS employees on the intranet site which typically houses interim guidance. Training with respect to the memorandum was provided to all offer specialists and COIC employees. Most recently, these procedures were incorporated into the revision of IRM 5.8, Offer in Compromise, which is currently in the clearance process. Once the procedures are published, we plan to complete additional training on ETA offers (hardship and non-economic hardship) in both the COIC sites and the field, and to all non-offer Collection employees to ensure they recognize when an ETA OIC may be appropriate.

In summary, the IRS has taken active steps to educate the public, practitioners, and IRS employees about ETA offers and will continue to evaluate our efforts and provide information

to each on an ongoing basis. We agree that in order to maximize the effectiveness of this authority, the availability of ETA offers and their parameters must be communicated to both taxpayers and IRS employees — and our efforts should aid and facilitate both in understanding when an ETA offer would be the appropriate remedy.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS now recognizes the important role that ETA offers play in the OIC program and the need to communicate the existence and virtues of its ETA authority to both taxpayers and IRS employees alike.

The IRS makes the case that it has made significant efforts to communicate about ETA offers. As noted above, in response to TAS's formal request for the IRS to identify "all external communications related to ETA offers" during FY 2006 and FY 2007, the IRS did not identify any, and TAS's research of the IRS's published IRM and training modules turned up only a few vague references to ETA offers outside of the IRM and training modules for offer specialists. TAS employees have recently encountered Collection Group Managers who have never heard of an ETA offer.<sup>16</sup> Additionally, TAS employees who recently attended Collection's Revenue Officer CPE stated that it provided little or no instruction on ETA offers. We acknowledge, however, that the IRS has made some effort to train employees and educate the public about this program. But, we are concerned that despite the IRS's communication efforts regarding ETA offers, the number of ETA receipts and acceptances has dropped significantly over the past two years. On the surface, it appears that those efforts have not been effective. Thus, the IRS should take a closer look at the reasons why ETA offers are not more widely utilized.

The IRS mentions that it has incorporated information about ETA offers into its Tax Phone Forums and external OIC stakeholder presentations, as well as revised the language in Form 656, Offer in Compromise and placed additional ETA information on the official IRS website. These are steps in the right direction. However, the content of these offerings contains scant detail to truly assist taxpayers with ETA offers. According to TAS personnel who have attended the IRS's external outreach presentations, little if any time is actually spent on the subject of ETA offers, and the material lacks examples that might help others determine if an ETA offer is the correct route to take.<sup>17</sup> Additionally, while we agree that the revised Form 656 is an improvement over prior versions, the guidance pertaining to ETA is still relegated to two paragraphs and does not include any examples that might show taxpayers under what circumstances an ETA offer would be an option. The same is true for the IRS's reference to ETA offers on its website. In order to facilitate a proper

<sup>16</sup> Email from Local Taxpayer Advocate (Sept. 11, 2007).

<sup>17</sup> Email from Local Taxpayer Advocate (Nov. 29, 2007).

awareness of ETA by external stakeholders, the IRS must ensure that taxpayers can understand its communications, even if they have no prior knowledge about the offer program.

Internally, the IRS has provided training and guidance about ETA offers to its employees directly involved in processing offers. The training courses provided to OIC personnel in FY 2007 included a two hour session devoted to ETA non-hardship offers and similar presentations were delivered by the ETA Non-Economic Hardship group staff to various OIC personnel as well as TAS during FY 07. Even so, IRS guidance to non-OIC employees is minimal. The IRS did issue the abovementioned interim guidance memorandum to all Compliance, Counsel, and Appeals employees in November 2006. However, no additional training has been provided to help employees who do not ordinarily process offers to recognize opportunities to use ETA offers and resolve routine casework.

The National Taxpayer Advocate is pleased that the IRS is in the process of incorporating the November 2006 memorandum, which discusses non-hardship ETA offers, into the IRM section used by employees who process offers. However, the IRS should also add a discussion of ETA offers (both those based on non-hardship and hardship) to all parts of the Collection IRM that involve financial analysis and enforcement actions (*e.g.*, levies, seizures, suits, etc.). Moreover, a discussion of economic hardship (per IRC § 6343) should also be included in such guidance.

The National Taxpayer Advocate agrees that by providing specific direction and guidance to both its employees and external stakeholders, and continually assessing the performance of OIC program results as they relate to ETA offers, the IRS will be better able to maximize the effectiveness of its OIC program. TAS is more than willing to assist the IRS in developing training and other materials for stakeholders and employees on this important collection alternative.

## Recommendations

The National Taxpayer Advocate recommends that the IRS:

1. Update all IRS internal guidance (including the IRM) which discusses available collection options to include a section on both hardship and non-hardship ETA offers. This is necessary to ensure that all OIC and non-OIC employees have the proper guidance to assist them with recognition of when an ETA offer may be appropriate. The guidance should also include a discussion of economic hardship (per IRC § 6343). Additionally, the IRS should provide more specific guidance and examples of situations where it is appropriate to accept an ETA offer on future revisions of Form 656 and the section of the IRS website devoted to OIC and ETA offers.
2. Require all IRS Collection employees to consider whether an ETA offer might be an appropriate collection alternative before determining to seize or recommending foreclosure on a personal residence.

3. Train all Compliance, Counsel, and Appeals personnel to ensure they can determine when it may be appropriate for the IRS to accept an ETA offer or refer an offer to the specialized ETA offer group for further analysis.
4. Conduct additional and more in-depth external outreach to better educate taxpayers and practitioners about when the IRS will accept ETA offers. It should focus outreach on taxpayers most likely to be eligible for ETA offers, such as delinquent taxpayers whose tax deposits have been embezzled by a payroll service provider, those located in areas devastated by natural disaster, and those who are about to lose their primary residence to foreclosure.
5. Ensure that employees who answer the phone when taxpayers dial the toll-free number listed in Form 656 have the training to provide the necessary assistance to taxpayers who may be eligible for ETA offers.

MSP  
#26**Assessment and Processing of the  
Trust Fund Recovery Penalty (TFRP)****Responsible Official**

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division

**Definition of Problem**

Employers are responsible for withholding income, Federal Insurance Contributions Act (FICA), and, where applicable, excise taxes from payments made to employees.<sup>1</sup> Such taxes are referred to as “trust fund” taxes because employers hold the employee’s money in trust until it is paid over to the government. When these monies are not paid as required, the law provides for the assessment of a Trust Fund Recovery Penalty (TFRP) against individuals who are deemed to be the “responsible persons.”<sup>2</sup> The penalty is equal to the amount of income and FICA taxes withheld from employees.<sup>3</sup>

The assessment of the TFRP can have disastrous economic consequences on those deemed responsible. Therefore, it is essential that the IRS follow all required investigative and administrative procedures when making such determinations, which include promptly processing requests for hearings before the Office of Appeals, and ensuring that all applicable payments and credits are timely and accurately applied towards TFRP assessments. The National Taxpayer Advocate has identified several aspects of the TFRP process that need improvement, including:

- Incomplete TFRP investigations;
- Delays by Collection personnel in sending taxpayer protests to Appeals;
- Failure to apply payments and credits accurately and in a timely manner;
- The lack of collectibility determinations prior to the assessment of the TFRP; and
- Collection policies that compromise the rights of taxpayers prior to an actual determination of a responsible person’s liability.

<sup>1</sup> IRC §§ 3102 and 3402(a) require employers to withhold FICA and income taxes from employees’ wages. Trust fund taxes also include excise taxes collected by businesses including taxes on communication services (IRC § 4251) and certain transportation by air (IRC §§ 4261 and 4271).

<sup>2</sup> IRC § 6672(a). “Responsible person” is generally defined as an officer or employee of the organization, who has sufficient control and authority to collect, truthfully account for, and pay over the withheld taxes, but willfully fails to do so. IRC §§ 6671(b) and 6672(a).

<sup>3</sup> See IRM 5.7.3.3.1 (Apr. 13, 2006) for factors determining personal responsibility and IRM 7.7.3.3.2 (Apr. 13, 2006) for factors determining willfulness.



## Analysis of Problem

### General Requirements of IRC § 6672

To establish liability under IRC § 6672, the IRS must conclude a person was responsible for withholding and paying over to the IRS payroll taxes and that the failure to do so was willful. A person's responsibility is based on his or her employment status, duty, and authority. The Code and Treasury Regulations are not specific regarding the factors to be considered in determining liability for the TFRP. However, the courts have settled on a variety of factors that may be considered, including:

- Contents of the corporate bylaws;
- Ability to sign checks on the company's bank account;
- Signature on the employer's federal quarterly and other tax returns;
- Payment of other creditors in lieu of the United States;
- Identity of officers, directors, and principal stockholders in the firm;
- Identity of individuals in charge of hiring and discharging employees; and
- Identity of individuals in charge of the firm's financial affairs.<sup>4</sup>

Courts do not uphold TFRP liability determinations based simply on the presence of one or more of these factors. No single factor is determinative of responsibility, and courts must look to the totality of circumstances.<sup>5</sup> Nonetheless, the TFRP statute can produce harsh results for those who technically meet the responsible person and willfulness criteria. Courts have described IRC § 6672 as a "tough statute" because employees can be held liable as responsible persons even though their superiors within the organization had directed them not to pay the taxes.<sup>6</sup>

The willfulness component of the statute is satisfied if the person has knowledge of the employer's obligation to pay withholding taxes and knew the funds were being used for other purposes.<sup>7</sup> Thus, a person has acted with willfulness if his or her actions were voluntary, conscious, and intentional as opposed to being merely negligent.<sup>8</sup>

<sup>4</sup> See *Brounstein v. U.S.*, 979 F.2d 952, 954 (3d Cir. 1992); *Bolen v. U.S.*, 956 F.2d 723, 727 (7th Cir. 1992) (holding that "significant control" does not necessarily mean "exclusive control").

<sup>5</sup> See *Barnett v. U.S.*, 988 F.2d 1449, 1455 (5th Cir. 1993); see also *Vinick v. U.S.*, 205 F.3d 1 (1st Cir. 2000) (holding company treasurer was not a responsible person because he lacked the actual authority or ability to pay the taxes owed).

<sup>6</sup> See *Thomas v. U.S.*, 41 F.3d 1109, 1115 (7th Cir. 1994) (holding that taxpayers satisfied the responsible person standard and acted with willfulness even though they were under direct orders from a superior not to pay the payroll taxes). In *Thomas*, one of the taxpayers quit his job when he realized that he could not prevent his employer from defaulting on its tax obligations; however, the court held: "Mr. Thomas departed only after he had seen on a weekly basis for three months that his employer would not pay the withholding taxes. He simply waited too long to quit to shield himself from the liability as a matter of law." *Id.*

<sup>7</sup> See *Hochstein v. U.S.*, 900 F.2d 543, 548 (2d Cir. 1990), *cert denied*, 504 U.S. 985 (1992).

<sup>8</sup> See *Kalb v. U.S.*, 505 F.2d 506, 511 (2nd Cir. 1974) (holding that a responsible person's reckless disregard concerning the payment obligation can satisfy the willfulness standard).

Multiple individuals can be deemed liable for the TFRP on the same delinquent account, but the IRS is prohibited from collecting more than the trust fund portion of the delinquent tax.<sup>9</sup> When multiple persons are deemed liable for the TFRP, all payments or credits applied to the assessments reduce the liability of all responsible persons, although individuals making payments are entitled to seek contribution from the others deemed liable.<sup>10</sup>

Taxpayers are entitled to an appeal of the proposed assessment.<sup>11</sup> The IRS Office of Appeals' determination is final and not subject to review by the U.S. Tax Court.<sup>12</sup> Taxpayers may contest the TFRP assessment by paying the liability or portion thereof and filing a suit for refund in the appropriate federal district court or the Court of Federal Claims.<sup>13</sup>

### TFRP Assessment and Collection Process

The IRS Collection function has the sole responsibility for recommending assertion of the TFRP.<sup>14</sup> The TFRP process begins when it is determined that a business has been delinquent on the trust fund taxes and one or more individuals were responsible for making the payment and willfully failed to do so.<sup>15</sup> The IRS then conducts a TFRP investigation, consisting of interviews with the potentially responsible person(s), gathering and reviewing documents, and looking at what role and responsibility the person(s) played in the day-to-day financial affairs of the business entity.<sup>16</sup> Once the IRS determines which responsible persons satisfy the responsibility and willfulness standards, the revenue officer is required to make a collectibility determination to establish whether or not the IRS is likely to be able to collect the trust fund penalty if it is assessed. If collecting the liability is doubtful (*e.g.*, taxpayer has minimal or no assets, is disabled with minimal income, etc.) then the revenue officer will generally recommend non-assertion in order to avoid the cost of assessing, accounting for and monitoring the assessments.<sup>17</sup>

The revenue officer next submits the determination of the responsible person(s) and the amount of liability to management for approval.<sup>18</sup> If management approves the recommendation, the revenue officer will freeze any tax refund to which the responsible person and his or her spouse may be entitled and issue Letter 1153, Proposed Assessment of Trust

<sup>9</sup> See IRC § 6672(a); see also IRM 1.2.1.5.14 P-5-60 (Feb. 2, 1993) (providing that the withheld income and employment taxes or collected excise taxes will be collected only once, whether from the business or from one or more of its responsible persons).

<sup>10</sup> See IRC § 6672(d).

<sup>11</sup> See IRC § 6672(b)(3); see also Rev. Proc. 2005-34.

<sup>12</sup> See *Moore v. Comm'r*, 114 T.C. 171, 175-76 (2000); see also *Pediatric Affiliates, P.A. v. U.S.*, 2006 WL 454374, 2 (D.N.J. 2006).

<sup>13</sup> See IRC § 6672(c)(2); *Henry Randolph Consulting v. Comm'r*, 112 T.C. 1 (1999).

<sup>14</sup> See IRM 8.11.2.4(1) (Sept. 12, 2006).

<sup>15</sup> See IRM 5.7.3.3 (Feb. 1, 2007).

<sup>16</sup> See IRM 5.7.4 (Apr. 13, 2006). Revenue Officers use Form 4180, *Report of Interview with Individual Relative to Trust Fund Recovery Penalty or Personal Liability for Excise Taxes*, to interview potentially responsible persons. See IRM 5.7.4.2.1 (Apr. 13, 2006).

<sup>17</sup> See IRM 5.7.5 (Apr. 13, 2006). The intent of this provision is to preclude assessments where the likelihood of collecting the assessment is doubtful.

<sup>18</sup> See IRM 5.7.4.5 (Apr. 13, 2006). The revenue officer accomplishes this process by completing Form 4183, *Recommendation re: Trust Fund Recovery Penalty Assessment*.

Fund Recovery Penalty, to the potentially responsible party.<sup>19</sup> Letter 1153 has important consequences for potentially responsible persons, as it informs them that the IRS is proposing to assess the TFRP and they have the right to appeal the proposed assessment within 60 days from the date of the letter.<sup>20</sup> The responsible person may consent to or protest the assessment.<sup>21</sup> The IRS assesses the penalty if it does not receive a signed consent form, properly filed appeal (for small cases under \$25,000), or protest (for cases over \$25,000).<sup>22</sup> Letter 1153 also extends the three-year statutory period for assessment by the longer of 90 days after the letter is mailed or, if the proposed TFRP assessment has been appealed, by 30 days after Appeals issues its final decision.<sup>23</sup>

If the taxpayer provides new or additional information showing that he or she should not be held liable for the TFRP and requests an appeal, the revenue officer may retract the proposal. If the revenue officer disagrees with the taxpayer's protest, he or she prepares a memorandum in support of the TFRP determination outlining the reasons for assessing the TFRP, and should generally provide all documentation to the Office of Appeals within 45 days.<sup>24</sup>

### Problems with the Collection and Assessment Process

The Taxpayer Advocate Service has received complaints from taxpayers, Local Taxpayer Advocates (LTAs), and practitioners regarding the following numerous aspects of the TFRP assessment and collection process.

#### *Incomplete TFRP Investigations*

The Internal Revenue Manual (IRM) sets forth the steps necessary to conduct a TFRP investigation to ensure the IRS arrives at the correct determination of responsible persons who should be held liable for the TFRP.<sup>25</sup> Failure by IRS employees to follow the established investigation procedure increases the likelihood of an incorrect or erroneous determination.

A recent quality review of TFRP cases demonstrates that the IRS often ignores its own investigative procedures. Using a sample of 1,702 cases, the IRS examined whether each of the following required steps were taken:

- An attempt to interview the potentially responsible person;
- An attempt to determine responsibility; and

<sup>19</sup> See IRM 5.7.4.7 (Aug. 30, 2007); see also Interim Guidance Memo, SBSE-05-0707-027, July 23, 2007 (imposing a freeze on potential Individual Master File (IMF) refunds of individuals liable for the TFRP, including non-liable spouses).

<sup>20</sup> Letter 1153 provides a 60 day period, from the date of the Letter 1153, to respond to the proposed assessment.

<sup>21</sup> See Rev. Proc. 2005-34; IRM 5.7.4.7 (Apr. 13, 2007). The responsible person should use Form 2751 to consent to or protest the assessment.

<sup>22</sup> See Rev. Proc. 2005-34 § 5.

<sup>23</sup> IRC § 6672(b)(3).

<sup>24</sup> See IRM 5.7.6.1.8 (Apr. 13, 2006).

<sup>25</sup> See IRM 5.7.4.2 (Apr. 13, 2006).

- An explanation of the provisions of the TFRP law was provided to the potentially responsible person.<sup>26</sup>

The results revealed that the IRS followed the required procedures in only 56 percent of the cases sampled. In 412 cases (24 percent), the IRS did not interview the potentially responsible person in accordance with existing quality standards. In 311 cases (18 percent), the IRS made no attempt to timely determine responsibility. In 652 cases (38 percent), the IRS did not explain the applicable provisions of the law to the potentially responsible persons, as required.<sup>27</sup> The National Taxpayer Advocate is concerned that failure to follow the established procedures may lead the IRS to erroneous liability determinations in some cases, or to violations of taxpayers' legal rights. Failure to conduct interviews with the potentially responsible person in accordance with quality standards may result in the IRS not receiving exculpatory evidence that the person might or could present to rebut the TFRP determination. Conversely, if the IRS does not pursue TFRP investigations when it should, affected taxpayers may avoid responsibility. Similarly, if the IRS does not explain the potential TFRP liability, responsible persons may not fully understand the consequences of failing to cooperate with the IRS.

### *High Abatement Rate*

The abatement rate is one indicator of systemic problems with the TFRP process.<sup>28</sup> To determine the effectiveness of the TFRP process, the TAS Research function obtained data that reflects the abatement rates of TFRP assessments from fiscal year (FY) 2002 through FY 2007. This data reveals that the IRS abated more than 28 percent of the TFRP assessments made during these four fiscal years.<sup>29</sup>

### *Delays in Transferring Cases to Appeals*

TFRP cases involve one of the most contentious and most litigated statutory provisions of the tax code.<sup>30</sup> The role of the Office of Appeals in the TFRP assessment process is critical to taxpayers who are contesting a TFRP liability and cannot obtain pre-payment judicial review of the IRS's determination. TAS has received complaints about Collection's delays in forwarding TFRP protests to Appeals.<sup>31</sup> The IRM provides that when a taxpayer protests the TFRP determination, the revenue officer should complete all required actions and

<sup>26</sup> See IRS, *National Quality Review System*, Oct. 1, 2005 through Sept. 30, 2006.

<sup>27</sup> IRM 5.1.10.3 details a series of steps that revenue officers should take during the initial contact, or early on in their investigation, including fully explaining the TFRP process and all of its ramifications.

<sup>28</sup> Treasury Inspector General for Tax Administration, *Federal Tax Deposit Penalties Have Been Significantly Reduced, but Additional Steps Could Further Reduce Avoidable Penalty Assessments*, Ref. No. 2005-30-136 (Sept. 2, 2005).

<sup>29</sup> Data obtained from IRS Enforcement Revenue Information System (ERIS) as of July 2007. Note: The percentage of abatements includes those accounts abated as a result of full payments made by the corporation; however, there is no reliable data available to show whether this is a significant factor.

<sup>30</sup> See IRM 8.11.2.7 (Sept. 12, 2006); see also National Taxpayer Advocate 2005 Annual Report to Congress 543.

<sup>31</sup> IRM 5.7.6.1.8(1) (Apr. 13, 2006) provides that revenue officers are required to send the file first to Technical Services which, in turn, forwards the case to Appeals.

forward the case to Appeals within 45 days.<sup>32</sup> However, the IRS currently takes an average of 138 days to send a TFRP case to Appeals – more than triple the time specified in the IRM.<sup>33</sup>

The following example demonstrates how delays adversely impact the potentially responsible person, as well as the tax practitioner or TAS LTA attempting to assist the taxpayer:

**EXAMPLE:** The revenue officer sent the potentially responsible person Letter 1153 proposing to hold the individual liable for the TFRP. The taxpayer's duly authorized representative filed a timely protest, insisting she was not a responsible person. The revenue officer failed to take the required steps necessary to forward the case to the Office of Appeals and continued to investigate the case and demand documents from the taxpayer, even though the taxpayer filed a timely appeal. Arguing that the statute of limitations for assessment was about to expire, the revenue officer assessed the TFRP liability against the individual without sending the case to Appeals.

The representative contacted an LTA who successfully advocated for abatement of the assessment by demonstrating the statute of limitations for assessment would not expire under IRC § 6672(b)(3) until the later of 90 days after the Letter 1153 had been mailed or 30 days after Appeals issues a final administrative determination on the case. Nevertheless, the revenue officer would not forward the case to Appeals. Frustrated, the potentially responsible person ceased communicating with her representative, the LTA, and the IRS Collection function.<sup>34</sup>

IRS revenue officers are supposed to follow the published administrative guidance<sup>35</sup> and understand that once the taxpayer timely files a protest, they must suspend further investigative efforts. Delays create unnecessary taxpayer burden and, as the above case illustrates, deter tax compliance. The IRS Collection function is aware of the problem regarding delays in getting such cases to Appeals, and has discussed ways of correcting the problem with the TAS.

<sup>32</sup> IRM 5.7.6.1.8(1) (Apr. 13, 2006) provides that a revenue officer must generally prepare a written rebuttal in response to an appeal from a potentially responsible person.

<sup>33</sup> Information provided by SB/SE in response to information request (Aug. 15, 2007).

<sup>34</sup> The TFRP is not subject to the deficiency procedures. See IRC § 6212(a) (§ 6212 applies only to any tax imposed by subtitle A (§§ 1-1563), subtitle B (§§ 2001-2704) and chapters 41 (§§ 4911-4912), 42 (§§ 4940-4967), 43 (§§ 4971-4980G), and 44 (§§ 4981-4982). Thus, after the IRS issues Letter 1153 to the potentially responsible person, if the person does not timely protest the proposed assessment, the IRS may assess the penalty and issue a notice and demand for payment requiring the responsible person to remit the payment within ten days, subject to collection, in "the same manner as taxes." See IRC § 6671(a), Rev. Proc. 2005-34. Consequently, if the penalty is not paid after notice and demand, collection procedures ensue. See IRC § 6321.

<sup>35</sup> See Rev. Proc. 2005-34; IRM 5.7.4.7 (Apr. 13, 2006).

### Lack of Collectibility Determinations

The IRM requires the investigating revenue officer to make a determination as to the collectibility of a TFRP assessment prior to making the assessment.<sup>36</sup> The intent of this provision is to preclude generating assessments that have little collection potential.<sup>37</sup> The IRS has recently concluded that collectibility determinations are not being made on a consistent or timely basis.<sup>38</sup> The failure to make this determination prior to the assessment process has contributed greatly to an average of 86 percent of TFRP accounts being deemed as currently not collectible (CNC), or reported as not collected. Table 1.26.1 below demonstrates that the IRS did not collect a significant percentage of TFRP assessments for FY 2002 through FY 2007.

**TABLE 1.26.1, TFRP Assessments Collected, FY 2002 – FY 2007<sup>39</sup>**

FY	Penalty Assessed (Amount)	Penalty Abated (Amount)	Penalty Collected	Percent Abated	Percent Collected
2002	\$ 1,604,171,972	\$ 541,920,696	\$ 229,825,284	33.8%	21.6%
2003	\$ 1,869,717,205	\$ 597,446,364	\$ 256,049,494	32.0%	20.1%
2004	\$ 2,299,048,445	\$ 945,128,512	\$ 234,095,196	41.1%	17.3%
2005	\$ 1,994,011,064	\$ 575,932,305	\$ 187,310,029	28.9%	13.2%
2006	\$ 1,745,777,952	\$ 332,928,583	\$ 117,894,974	19.1%	8.3%
2007	\$ 1,470,865,664	\$ 110,272,471	\$ 38,465,253	7.5%	2.8%
<b>Totals</b>	<b>\$10,983,592,302</b>	<b>\$3,103,628,931</b>	<b>\$1,063,640,230</b>	<b>28.3%</b>	<b>13.5%</b>

The unpaid or delinquent trust fund accounts, which give rise to the assertion of the TFRP, are treated as higher priority accounts, meaning revenue officers are required to work them before other, lower priority delinquent accounts.<sup>40</sup> The data cited above suggest the IRS may not be receiving a return on its investment commensurate with the attention given to these accounts. Making collectibility determinations prior to assessment of the TFRP can improve the efficiency of tax administration by only assessing liabilities that have collection potential.<sup>41</sup>

<sup>36</sup> IRM 5.7.5.3.1 requires the submission of Form 9327, *Recommendation of Non-Assertion of the TFRP Based on Collectibility*. The IRM provides that the collectibility determination “must” be made.

<sup>37</sup> See IRM 5.7.5.3.1(2) (Apr. 13, 2006).

<sup>38</sup> IRS, *TFRP Virtual Team* (May 31, 2006).

<sup>39</sup> The percentage collected is based on the amount of assessment remaining after abatements.

<sup>40</sup> The highest priority cases, including TFRP cases, bypass the IRS’s Automated Collection System, and are worked by revenue officers. See IRM 5.1.1.13.4.2(1) (Jan. 1, 2003).

<sup>41</sup> The IRS has acknowledged in the past that TFRP collection rates are not productive relative to other types of cases and that it will forgo such cases for more productive cases. Treasury Inspector General for Tax Administration, *The New Risk-Based Collection Initiative Has the Potential to Increase Revenue and Improve Future Collection Design Enhancement*, Ref. No. 2004-30-165 (Sept. 2004). The IRS needs to use the collectibility determination so that it can better determine which cases it should devote its resources.

### *Problems with IRS Accounting Systems on TFRP Payments*

TAS has also received complaints about the inability of IRS data systems to properly cross-reference payments or credits made by the business or individuals when more than one person has been assessed the TFRP.<sup>42</sup> Unfortunately, IRS systems have no reliable cross reference capabilities to apply payments or credits from one responsible person to the outstanding liability of others against whom the same assessment was made. Audits of IRS payment processing systems by the Government Accountability Office (GAO) reveal potential inaccuracies in 11.3 percent of TFRP payment transactions posted to accounts since August 2001 and still outstanding in FY 2006.<sup>43</sup>

The IRS has recently taken steps to mitigate this problem. In July 2003, the IRS began using its new Automated Trust Fund Recovery system (ATFR), which the IRS believed would reduce errors. However, the GAO still noted the same types of problems even after implementation of the new system. The IRS has also completed Release 1 of its new Custodial Detail Database (CDDDB), the first step toward allowing the IRS to maintain subsidiary ledgers on TFRP accounts, which will automatically update related TFRP accounts.<sup>44</sup>

### *Collection Initiatives*

In light of the low collection rates on TFRP cases compared with the relatively high priority placed on these cases, it is understandable that IRS would design initiatives to enhance collection results. However, in doing so, it is essential that these initiatives maintain a proper balance between improving collection rates and taxpayer rights. Recently, the IRS has taken a more aggressive collection posture toward individuals and their “non-liable” spouses. The IRS recently implemented a process that freezes joint refunds of both spouses prior to a final determination on whether the taxpayer is liable for the TFRP. This process is described in the abstract from the policy memorandum:

Once Form 4183, Recommendation re: Trust Fund Recovery Penalty Assessment, is approved by the group manager, the revenue officer will prepare Form(s) 3177, Notice of Action for Entry on Master File, to request input of a freeze on any potential refunds for all individuals determined to be responsible for the TFRP. This will also include a request for a freeze on any refund that may be due their respective spouses, if any; in the event the couple files a joint refund income tax return under the non-liable spouse’s Social Security Number (SSN).<sup>45</sup>

This guidance directs employees to freeze refunds that are due persons who may have no TFRP liability, *i.e.*, a potentially responsible person whose case has not yet been heard by Appeals, and others who clearly have no responsibility for the TFRP, *i.e.* “non-liable” or

<sup>42</sup> The TFRP can only be collected once. See IRC § 6672(a); see also IRM 1.2.1.5.14 P-5-60 (Aug. 17, 2000).

<sup>43</sup> Government Accountability Office, GAO-07-136, *IRS’s Fiscal Years 2006 and 2005 Financial Statements* 131-132 (Nov. 9, 2006).

<sup>44</sup> *Id.*

<sup>45</sup> Government Accountability Office, GAO-07-136, *IRS’s Fiscal Years 2006 and 2005 Financial Statements* 131-132 (Nov. 9, 2006).



innocent spouses. This recent shift in IRS policy violates taxpayers' rights and does not reflect a proper balance between the IRS's interest in collecting the proper amount of tax (since the correct amount of tax has not yet been determined) and the taxpayers' right to a refund of overpaid taxes. For example, the new policy will result in a freeze on the non-liable spouse's refund when he or she files a separate return.

### Conclusion

The TFRP process is a necessary and appropriate tool available to the government to collect the trust fund portion of employment taxes. The administrative guidelines and procedures appear to be well defined and appropriate under current law. However, as noted herein, too often the IRS ignores its own guidelines and procedures, which can delay cases going to Appeals or generate erroneous assessments. The IRS should ensure that its revenue officers fully appreciate the importance of following the IRM and Revenue Procedure 2005-34 while determining responsibility in TFRP cases. The IRS should take steps toward assessing the TFRP only upon completion of a full investigation delineated by the IRM and Revenue Procedure 2005-34, and avoid a "shotgun" approach.

We applaud the IRS for its continued effort to improve its accounting systems for TFRP payments. We also encourage the IRS to aggressively move forward with the next stages of those improvements so that the problems with matching payments being experienced by taxpayers deemed liable for the TFRP are minimized. Finally, we recommend that the IRS reverse its decision to freeze refunds that may be due non-liable spouses.

### IRS Comments

The IRS agrees that it is essential for our employees to follow investigative and administrative procedures when making Trust Fund Recovery Penalty (TFRP) determinations. As the report notes, we have taken the concerns recently expressed by the National Taxpayer Advocate very seriously and have taken steps to insure that cases proceed in a timely manner. We have also continued our focus on improving our systems' ability to accurately account for payments made and cross-reference payments between related TFRP accounts.

### TFRP Investigations

With respect to the concerns regarding incomplete TFRP investigations, case quality is a major focus for the IRS and is emphasized in both the Collection Program letter and business plans for FY 2008. While we recognize that quality in TFRP cases could be improved, the quality data cited in the report addresses only the actions that are taken on initial contact with the taxpayer. Nevertheless, effective first contact with taxpayers is one of the areas we are focusing on and we hope to see improvement in these quality measures. In March 2007 each Collection Area developed a quality improvement action plan separate from their normal business plans. A mandated component of each area's plan was to conduct targeted non-evaluative reviews on specific elements that have dropped five percent or

more in each attribute. SB/SE Collection will continue to conduct these reviews in FY 2008 as part of our Quality Action Plans.

### Abatement Rate

The IRS does not agree that a high abatement rate is necessarily an indicator of systemic problems. All reductions in TFRP assessments currently recorded as “abatements” are not, in fact, determinations that an erroneous assessment has been made. Financial Management Information System (FMIS) data for FY 2006 shows that 82 percent of TFRP transactions coded as “abatements” were actually adjustments to accounts because of payments on related responsible persons’ TFRP assessments or on the underlying corporate trust fund liability. Actual abatements may also result from a debtor’s successful completion of a Chapter 13 payment plan.

### Transferring Cases to Appeals

The IRS agrees that the role of the Office of Appeals in the TFRP assessment process is critical to taxpayers who are contesting a TFRP liability. The IRS is aware of the problem regarding delays in getting cases to Appeals and we are working with the field, Appeals, and TAS to correct this problem. In fact, we have developed a report to help area directors focus on cases in which a TFRP assessment has been proposed but no further action has been taken within prescribed timeframes. This inventory management tool will enhance oversight of TFRP cases by enabling management to hold employees accountable for delays in specific cases.

### Collectibility Determinations

Our procedures currently require the investigating officer to make a collectibility determination prior to assessment of the TFRP to preclude generating assessments that have little or no collection potential. We have been unable to locate any valid statistical data that indicates that this is not being done. According to the IRS Business Performance Management System, 18.6 percent of existing TFRP modules were in CNC status based on collectibility closing codes at the end of FY 2007. Another five percent of TFRP modules were in CNC status as a result of a temporary, systemic “burn off” due to resource issues which have no relation with collectibility.

As discussed above, the TFRP may sometimes be assessed on multiple individuals, and accordingly, we would not expect to collect the entire assessed amounts. Abatements are also made to adjust accounts because of payments on related responsible persons’ TFRP assessments or on the underlying corporate trust fund liability. Actual abatements may also result from a debtor’s successful completion of a Chapter 13 payment plan.

### Accounting Systems for TFRP Payments

The IRS appreciates the acknowledgement of our improvements in this area and agrees that continuing progress is needed. TIGTA also acknowledged our efforts in a recent audit report (Reference No. 2007-10-183 dated September 21, 2007) and stated that progress is being made in addressing the reliability of TFRP transaction information recorded in taxpayer accounts. It also stated that the IRS continues to make progress in its efforts to develop and implement an effective methodology for readily and accurately accounting for TFRP transactions.

The IRS is aware of the data systems' weakness to properly cross-reference payments or credits made by the business or individuals when more than one person has been assessed a TFRP. We have been working to mitigate this problem by updating our systems to automatically cross-reference the payments.

The Automated Trust Fund Recovery (ATFR) application systemically executes a full review of all transactions on a TFRP account every time a new transaction occurs. As a result, any prior errors in linkage of the accounts or cross-referencing of payments/credits are identified and addressed, minimizing the potential for incorrect taxpayer account balances being carried forward.

The IRS began a Trust Fund Recovery Penalty Database Cleanup Initiative in September 2006. The purpose of the initiative is to complete a 100 percent review of all TFRP related accounts to ensure that all linkages and payment applications are accurate. Progress has been made in addressing the reliability of TFRP transaction information recorded in taxpayer accounts. We expect to complete the cleanup initiative in the second quarter of 2008 and anticipate that it will result in further improvement.

We have been monitoring the impact of the cleanup using reports provided by the Chief Financial Officer. The reports measure the overall accuracy of the TFRP accounts and the latest report reflected an 18 percent reduction in errors related to correct account linkage and cross-referenced payments over last year.

### Collection Initiatives

With respect to the concerns regarding refund freezes, the TC 130 refund freeze process represents a longstanding IRS practice to reach account overpayments legally due the government when systemic programming does not provide for their automatic offset. This procedure is also used for certain income tax, non-master file, and Treasury Offset Program liabilities when a person liable for an unpaid tax may be filing jointly with someone not liable for that liability. Once the TFRP investigation has been completed, the revenue officer has determined the liable individuals, and the group manager has approved the TFRP recommendation, action is taken to freeze the refund of the individuals deemed liable. When the possibility exists that an individual may file as secondary spouse on a joint return, the IRS can freeze the potential joint refund under the spouse's SSN. When this happens, the

account is reviewed and if the impacted individual does not owe any federal liabilities, the refund is issued within eight weeks of the return posting.

Unlike with other types of tax, the Integrated Data Retrieval System (IDRS) does not currently allow for systemic offset of a TFRP liability of a secondary spouse on a joint income tax return. We anticipate that corrective programming will occur in January 2008; thereby obviating the need for a TC 130 input on the spouse of the person assessed the TFRP.

## Taxpayer Advocate Service Comments

We are both appreciative of and pleased with the IRS comments. It appears that the IRS and the National Taxpayer Advocate agree on the majority of the issues and concerns in the report. We note that the IRS response details a number of remedial actions in place or underway that will address many of our concerns. The National Taxpayer Advocate has proposed a series of recommendations that, if adopted, will complement and bolster the actions taken by the IRS to significantly enhance the quality, efficiency, and effectiveness of the TFRP process. Still, some issues warrant a further response or clarification.

### *TFRP Investigations*

While the quality review data provided to the IRS focused on the required investigative activities during the initial contact with the taxpayer, it is not disputed that the failure to conduct an effective and substantive initial contact undermines the integrity of the entire investigative process. For example, the failure to interview key persons early on, or to secure documentation and evidence when it is available, erodes the basis for TFRP assessment recommendations. More importantly, the failure to inform all potentially liable persons that they can be assessed the TFRP and held personally liable defeats the intended deterrent effect of the TFRP in fostering voluntary compliance. We believe that the FY 2008 focus on specific quality attributes of casework, referenced in the IRS response, should have a significant and positive impact on this and other aspects of the TFRP process.

### *Abatement Rate*

The National Taxpayer Advocate has acknowledged that the abatement rates are affected by a number of factors, including those referenced in the IRS response. In its initial response to this issue, the IRS indicated that our data (from ERIS) was misleading and could cause erroneous conclusions to be drawn. The IRS response shown above now indicates that the system relied upon for the initial IRS response (FMIS) reflects “abatements” that should have been coded as “adjustments.” The IRS contends that neither system produces data that is correctly or accurately labeled or described. This response, coupled with the response to the discussion of Accounting Systems for TFRP Payments, which acknowledges significant problems in accounting for and crediting payments, strongly suggests that the IRS cannot provide data that accurately reflects the performance of the TFRP process.

To measure the performance of the entire TFRP assessment process, which includes pre-assessed and assessed TFRP liabilities, the National Taxpayer Advocate sought data to determine the rate at which Appeals does not sustain proposed TFRP assessments. This data would offer some indication as to whether revenue officers are conducting TFRP investigations that are supported by documentation and meet the statutory and administrative requirements to support the proposed assessments. The IRS Appeals function does not capture this data. The National Taxpayer Advocate also sought data that would show the rate at which revenue officers reversed proposed assessments, based on taxpayer responses that provide additional information or documentation to refute the basis for the proposed assessment. Again, the IRS does not capture this data. While the IRS can continue to debate what the abatement data actually represents, the National Taxpayer Advocate remains concerned with the quality and effectiveness of the entire TFRP process.

### *Transfer of Cases to Appeals*

We applaud the IRS for taking steps to shorten the length of time needed for cases to be forwarded to Appeals; however, the National Taxpayer Advocate does not feel these actions will fully address the concern. For example, the processing guidelines provide for a 45-day window to forward the case to Appeals, but this is a suggested, rather than required, timeframe. The impact of failing to follow the suggested timeframe must be viewed in context. In addition to the inordinate delay in sending the case to Appeals, the IRS must consider that the average cycle time to process the case once it reaches Appeals (as of July 31, 2007) is 317 days.<sup>46</sup> When that time is added to the 138 days it takes for Collection to forward the appeal, the average taxpayer cannot expect to receive a decision on his or her appeal for approximately 15 months. This is unacceptable by any measure.

The IRS has recently developed and implemented an inventory management report to track the timeliness of cases that must be forwarded to Appeals. The report, if used and monitored as intended, is a significant and positive step in addressing our mutual concerns. We would urge that the report specifically track and monitor appeals that have been requested but not forwarded to Appeals within 60 calendar days.

### *Collection Determinations*

The IRS states that it cannot find any valid statistical data to show that collectibility determinations are not being made. While there may not be empirical data, the National Taxpayer Advocate notes that the “TFRP Virtual Team” formed and chartered by the SB/SE Director, Collection, published its findings in a newsletter to all Collection employees on May 6, 2007. The team concluded, without any stated caveat, that collectibility determinations were not being made.

On several occasions, the National Taxpayer Advocate requested any and all reports, information, or data produced by the “virtual team” in its study of the TFRP process but did not

<sup>46</sup> Appeals response to TAS information request (Aug. 30, 2007).

receive a response. There was no indication, then or now, that the conclusion and findings of the team chartered to review the TFRP program are erroneous or unreliable.

### *Collection Initiatives*

The IRS argues that the process change, wherein the innocent spouse's SSN is blocked or frozen to preclude refunds, is a longstanding procedure and is fully warranted to offset liabilities that are "legally due the government." Our concern is not the lawful and appropriate offset of refunds to established and assessed liabilities but the fact that the IRS now places the freeze on the SSNs of both the potentially liable spouse and the non-liable spouse. The IRS takes this action immediately upon concurrence of the Collection group manager, and prior to informing the taxpayers that it was taken.

The IRS did not consider the significant consequences of this process change on both the innocent spouse, or on the IRS itself. For example, the National Taxpayer Advocate first raised the concern that the new process would disrupt the legitimate refund due the innocent spouse who chooses to file a separate return. The IRS requested an opinion from Counsel as to the legality of freezing the non-liable spouse's SSN. There was no mention of, or reference to, the scenario wherein the non-liable spouse files separately. The opinion was provided in a series of email, rather than in a formal document that outlined the issues, legal theory or findings, taxpayer equity issues, and other information that would generally be provided in such matters. In fact, it does not appear that the IRS even recognized this scenario before implementing this program.

The IRS has previously argued that the non-liable spouse has other options for seeking relief, including the issuance of a manual refund if he or she experiences and can prove a financial hardship. The problem with that argument is that the non-liable spouse is forced to contest a liability that is not owed, endure the administrative process of getting the refund released, and prove financial hardship to secure a refund that is lawfully due in the first place. Meanwhile, the IRS will expend considerable energies in sending notices, monitoring and processing responses, handling phone calls and other inquiries, generating manual refunds, and performing many related tasks. The IRS has acknowledged that this new procedure will result in additional injured spouse claims that are labor intensive for employees and cumbersome for taxpayers. In fact, the Taxpayer Advocate Service is likely to experience the largest increase in referrals, requests for manual refunds, injured spouse claims, and telephone traffic from the adversely impacted spouses.

The IRS contends that new computer programming due to roll out in January 2008 will solve these issues. The National Taxpayer Advocate will continue to monitor the issue to determine whether the new system indeed adequately resolves a problem that is of the IRS's own creation. More importantly, the National Taxpayer Advocate is disappointed that the IRS, before implementing this procedure, failed to consider the situation from the taxpayer perspective.

## Recommendations

The IRS has taken or is taking specific measures to address many of our concerns. We believe these continued efforts to improve the current TFRP process should produce tangible and measurable benefits for both the taxpayers and the IRS. We also recognize that many of the concerns we have expressed are more difficult to resolve because of the limitations of the computer systems used in the complex TFRP process. However, the IRS has not previously been able to implement effective systems that would resolve many of our mutual concerns, despite the persistent negative findings by GAO and TIGTA. The IRS must ensure that the new system, scheduled for implementation in January 2008, is fully supported and is given the highest priority.

To supplement the initiatives undertaken by the IRS to address our concerns, we provide the following recommendations:

1. The IRS, prior to implementing any further changes to the TFRP process, should confer with the National Taxpayer Advocate and other stakeholder functions, such as the Office of Taxpayer Burden Reduction (OTBR) to assess the potential impact on taxpayers. The IRS should also consult external stakeholder groups and partners to ascertain their perspective on the change. This approach would serve several purposes:
  - a.) To determine if there is a less intrusive alternative;
  - b.) To leverage the resources of the National Taxpayer Advocate and outreach functions such as SB/SE Communications, Liaison & Disclosure to communicate to external stakeholders the “when, how, and what” of the change, and to offer suggestions for dealing with it in an effective and efficient manner; and
  - c.) To determine downstream workload increases or impact on both internal and external customers.
4. The 45-day period for routing TFRP cases to Appeals should be a requirement, rather than a suggested timeframe and should be enforced. Further, any appeal that is not forwarded within 60 calendar days should undergo a mandatory review and the reason for the delay should be documented. We also recommend that revenue officers be required to acknowledge and begin processing a request for an appeal within ten business days.
5. The IRS should cease inputting a freeze on the SSN of the non-liable spouse until computer or systemic processes are in place to monitor and freeze only those refunds that are due persons filing joint tax returns. Additionally, the Computer Paragraph 44 (CP44), a generic notice sent to taxpayers whose refund has been or will be frozen, should be rewritten to contain detailed and clear instructions on how a taxpayer can contest the freeze and apply for injured spouse relief when the refund is due from a jointly filed return. A Form 8379, Injured Spouse Allocation, should be attached to the notice CP44 and the notice should list the name and



number of the IRS employee who can explain the process, answer questions, and appropriately address the taxpayer's concerns. Most importantly, the IRS should be prepared to conduct an expedited review of cases where the non-liable spouse has filed separately and is due a refund, which was frozen under the new policy, in order to release the freeze code and have the refund issued promptly. The IRS should not rely on usual freeze release procedures, which could delay the refund for eight weeks or longer. We must note that the non-liable spouse who files separately does not qualify under injured spouse provisions, which are limited solely to refund arising from jointly filed returns. The National Taxpayer Advocate is not reassured that the review process noted in the IRS response will prove effective or preclude the expenditure of significant resources by both the IRS and TAS, not to mention the burden imposed upon the taxpayers.

6. The IRS should update the training provided to revenue officers using actual case examples, provided by Appeals, TAS, and the campuses, which would reflect both ideal and unacceptable case actions. The training should include a specific discussion of the impact on internal and external stakeholders when case actions are not timely, appropriate, or fail to meet minimum quality standards. TAS would support this effort by reviewing the proposed training materials and offering suggestions and feedback.

## Status Update: Private Debt Collection

### Responsible Official

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division

### Definition of Problem

The collection of federal tax debt is a core governmental function. As Supreme Court Justice Owen Josephus Roberts noted, “Taxes are the lifeblood of government.”<sup>1</sup> To ensure that this “lifeblood” flows steadily, Congress has sought over several decades to balance the Internal Revenue Service’s unrivaled collection powers with equally strong protection of taxpayers’ rights.<sup>2</sup> Congress also established the position of the National Taxpayer Advocate to help ensure that taxpayer rights are protected, and requires the National Taxpayer Advocate to report annually to Congress – without any executive branch intervention – at least 20 of the most serious problems encountered by taxpayers.<sup>3</sup>

The Private Debt Collection (PDC) program, as currently administered, turns the concept of taxpayer rights on its head. Since the program was first proposed in 2002, it has been the National Taxpayer Advocate’s role to make sure that taxpayer protections applicable to IRS collection personnel apply with equal force to Private Collection Agency (PCA) personnel. The National Taxpayer Advocate’s initial acceptance of this program was conditioned on the premise that there would be a “level playing field” between tax collection as practiced by IRS employees and tax collection as practiced by PCA employees.<sup>4</sup>

Today the PDC initiative is failing in most respects. It is not meeting revenue projections.<sup>5</sup> It is not more successful than the IRS at finding hard-to-locate taxpayers.<sup>6</sup> It is significantly

<sup>1</sup> *Bull v. U.S.*, 295 U.S. 247, 260 (1935).

<sup>2</sup> See Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342 (1988) (containing the Taxpayer Bill of Rights); Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 110 Stat. 1452 (1996); and Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685 (1998).

<sup>3</sup> See IRC § 7803(c).

<sup>4</sup> *IRS Private Debt Collection: Hearing Before the H. Comm. on Ways and Means*, 110<sup>th</sup> Cong. 1<sup>st</sup> Sess. (May 23, 2007) (statement of Nina E. Olson, National Taxpayer Advocate); National Taxpayer Advocate Fiscal Year (FY) 2008 Objectives Report to Congress xvi; National Taxpayer Advocate 2006 Annual Report to Congress 49; National Taxpayer Advocate 2005 Annual Report to Congress 78; IRS, *Use of Private Debt Collection Agencies by the IRS: Hearing Before the Subcommittee on Oversight of the H. Comm. Ways and Means*, 108<sup>th</sup> Cong. 1<sup>st</sup> Sess. (May 23, 2003) (statement of Nina E. Olson, National Taxpayer Advocate).

<sup>5</sup> Previously the PDC initiative projected the program’s FY 2008 revenue as \$88 million. IRS, *Filing and Payment Compliance Advisory Council* (May 1, 2007) at 15. However, the IRS has revised its FY 2008 revenue projections downward to between \$23 million and \$30 million. E-mail from IRS Deputy Director, PDC Program Office, to TAS Attorney Advisor (Oct. 25, 2007).

<sup>6</sup> IRS, *Private Debt Collection, Interim Report on the Cost Effectiveness Study* at 5. This report shows that the PCAs only collect 4.9 percent of the “unable to contact” (UTC) and “unable to locate” (UTL) cases. When considering the IRS’s UTL and UTC ending inventory for FY 2006 and new UTL/UTC cases for FY 2007, 4.7 percent were reactivated. Reactivation indicates the IRS found the taxpayer or a levy source; however, the IRS does not separately track resolution of these cases. Moreover, when considering the total IRS currently not collectible (CNC) inventory (FY 2006 ending CNC inventory plus FY 2007 new CNC cases), the IRS collected full pay on an additional 6.8 percent.

less successful than IRS employees at fully resolving taxpayer past due accounts.<sup>7</sup> Most importantly, the IRS has placed the interests of the PCAs above the interests of taxpayers and tax administration by failing to require the PCAs to disclose training materials, scripts, letters, and operational plans relating to taxpayer contact – items that the IRS itself must disclose about its own collection operations. By doing so, the IRS substantially undermines the concept of a level playing field by allowing the telephone calling scripts and related information about how PCAs deal with taxpayers to be concealed from public view and scrutiny. Moreover, in failing to require disclosure of such materials, the IRS impedes the National Taxpayer Advocate’s ability to fulfill her statutorily mandated duty to report to Congress about her concerns.

## Analysis of Problem

### Background

The National Taxpayer Advocate has had concerns regarding the PDC initiative since its inception and these concerns have multiplied since the PCAs began collecting debts.<sup>8</sup> The IRS has taken steps to address these concerns and mitigate the threat to taxpayers and their rights, such as removing all taxpayer information from the PCAs once the contract has ended and informing taxpayers of their right to opt out of the initiative and work directly with the IRS. Although the National Taxpayer Advocate applauds these steps, the IRS’s current approach to the PDC initiative compromises both taxpayer rights and tax administration.

The initiative also has failed to demonstrate that it makes good business sense. Since its beginning in September 2006, when the IRS started to place inventory with three PCAs, the initiative has not produced the results the IRS projected.<sup>9</sup> For instance, since September 2006 the PCAs have brought in less revenue than the IRS’s most conservative projections, leading the IRS to recalculate its revenue projections and expand the types of cases referred to the PCAs so that the PCAs can meet revenue targets. The PCAs’ underperformance has also led the IRS to push back the date by which the PCA initiative will recoup its costs. Moreover, as measured against the IRS’s performance, the PCAs’ performance is lackluster at best.

<sup>7</sup> IRS, *Filing Payment Compliance Advisory Council 5* (Nov. 11, 2007); IRS, *SB/SE Collection Activity Report 5000-2* (Oct. 18, 2007). The PCAs closed only nine percent of their inventory by full pay or installment agreement (installment agreement entity closures were converted to modules by the average number of modules per entity for PCA installment agreement cases), whereas the IRS closed 32 percent of its comparable inventory (FY 2007 W&I ACS full pay and installment agreement dispositions divided by sum of Wage and Investment (W&I) ACS 2006 ending inventory and FY 2007 receipts). The PCAs’ resolution results may have been hampered by the typical lag between case receipt and resolution (e.g., PCAs likely had few case resolutions at the beginning of FY 2007 since their case inventory would only have been one month old). W&I ACS results were compared to PCA results since these IRS cases are most similar to the IRS test ACS next best case test group in the Cost Effectiveness Study. Validated data from the IRS test group was not available at the writing of this report.

<sup>8</sup> National Taxpayer Advocate 2006 Annual Report to Congress 52; *IRS Private Debt Collection: Hearing Before the H. Comm. on Ways and Means*, 110<sup>th</sup> Cong. 1<sup>st</sup> Sess. (May 23, 2007) (statement of Nina E. Olson, National Taxpayer Advocate).

<sup>9</sup> IRS, *Filing Payment Compliance Advisory Council 9* (Sept. 26, 2007).

### PCAs' Failure to Meet Program Expectations

As the PDC initiative continues, it becomes more evident that the IRS's return on investment is not what the IRS originally expected and the IRS's rationales and justification for the initiative have not materialized. For example, the IRS stated previously that the use of PCAs is a cost effective method of collecting tax liabilities that the IRS could not otherwise reach with its existing resources.<sup>10</sup> However, recent data illustrates the cost effectiveness of the initiative is questionable.

### *Dollars Collected by PCAs Are Below Revenue Projections*

The IRS projected the initial stages of the PDC program (known as release 1.1 and 1.2) would cost \$71 million and bring in approximately \$134 million.<sup>11</sup> In fact, from October 2006 through September 2007, the initiative has collected a total of \$31 million, but brought in only \$25 million as a direct result of PCA contacts.<sup>12</sup> The IRS itself directly collected \$6 million – or 19 percent – of the gross collections without any involvement from the PCAs.<sup>13</sup> After deducting commissions paid to the PCAs, the true net revenue from PCA (non-IRS) collection activity is only \$20 million.<sup>14</sup> For fiscal year (FY) 2008, the IRS is now projecting gross PCA revenue of between \$23 million and \$30 million, far less than its original estimate of \$88 million.<sup>15</sup>

Earlier this year, the IRS projected the PDC initiative would bring in between \$1.5 and \$2.2 billion in gross revenue (before commissions) over the next ten years.<sup>16</sup> The IRS is currently revising its ten-year projection for the PCA program downward to reflect the PCAs' lower collection performance.<sup>17</sup> The midpoint of the original ten-year range is \$1.85 billion, so to meet this projection the IRS would need to average \$185 million per year on a gross basis (before commissions and IRS administrative costs). It appears the IRS is not even close to meeting this target. As noted above, the PCA initiative only collected \$31 million in gross revenue for FY 2007 and is projected to collect only \$23 million to \$30 million for FY 2008.

Not only have the PCAs' low yields made it clear that the IRS can collect these liabilities more efficiently, but even the IRS acknowledges it can accomplish the task better than the

<sup>10</sup> *Private Debt Collection: Hearing Before the Subcomm. on Oversight, House Comm. on Ways and Means*, 108<sup>th</sup> Cong., 1<sup>st</sup> Sess. (May 13, 2003) (statement of Mark W. Everson, Commissioner of Internal Revenue).

<sup>11</sup> IRS, *Filing and Payment Compliance Advisory Council* (May 1, 2007) at 15.

<sup>12</sup> IRS, *Filing and Payment Compliance Modernization Briefing*, PDC (Nov. 7, 2007) at 6.

<sup>13</sup> IRS, *Filing and Payment Compliance Advisory Council* (Nov. 7, 2007) at 3. The \$6 million collected by the IRS also includes Federal Payment Levy Program (FPLP) payments, State Income Tax Levy Program (SITLP) payments, monies received with amended returns, dollars collected after cases were recalled from the PCA whose contract was not renewed, and payments received after cases otherwise were recalled from a PCA.

<sup>14</sup> IRS, *Filing and Payment Compliance Advisory Council* (Nov. 7, 2007) at 3.

<sup>15</sup> E-mail from Director, PDC Program Office, to National Taxpayer Advocate (Nov. 20, 2007).

<sup>16</sup> IRS, *Filing and Payment Compliance Advisory Council* (May 1, 2007) at 14.

<sup>17</sup> E-mail from Director, PDC Program Office, to National Taxpayer Advocate (Nov. 20, 2007).

private firms.<sup>18</sup> The Department of the Treasury estimates that the PCAs bring in a four dollar return for every dollar the IRS invests.<sup>19</sup> In contrast, for every dollar the IRS invests in collecting tax liabilities, it generates a return of about \$20.<sup>20</sup> The IRS has estimated it will spend \$71 million through FY 2007 on startup and ongoing expenses for the PDC program. Thus, if the IRS had allocated the \$71 million towards its Automated Collection System (ACS) instead, we estimate the IRS could have brought in up to about \$1.4 billion, compared to the PCAs' \$31 million.<sup>21</sup>

Even if the cost of the PDC initiative declines dramatically, the IRS would likely be better off spending the funds to hire its own collection personnel. In FY 2008, the IRS estimates program, business project, contractor, and related IRS information technology costs for the PDC initiative will be \$7.35 million.<sup>22</sup> By our estimate, the IRS would collect over \$146 million if it applied that \$7.35 million to ACS, while the IRS projects the PDC initiative will bring in at most \$30 million in gross revenue in FY 2008. Therefore, the IRS would come out at least \$116 million ahead by applying the actual costs of program maintenance and supervision to ACS instead of the PDC program.

In fact, comparing PCA and ACS collection data offers evidence of what was already clear: the IRS can collect these liabilities more efficiently. For instance, through September 2007, the IRS placed with the PCAs 58,976 taxpayer accounts consisting of 107,019 modules (individual tax years).<sup>23</sup> The PDC Project Office stated that some type of action to either locate or attempt to contact the taxpayer has been taken on every case in the PCA inventory.<sup>24</sup> However, of the 107,019 modules placed with the PCAs from October 2006 through September 2007, only 10,157 modules, or nine percent of the total received by the PCAs, have been resolved by a full payment or installment agreement.<sup>25</sup> On the other hand, ACS

<sup>18</sup> *FY 2007 Appropriations for the Internal Revenue Service: Hearing Before the Subcomm. on Transportation, Treasury, Housing and Urban Development, and the District of Columbia of the H. Comm. on Appropriations*, 109<sup>th</sup> Cong. 2<sup>nd</sup> Sess. (Mar. 29, 2006) (testimony of Mark W. Everson, Commissioner of Internal Revenue).

<sup>19</sup> Testimony of United States Treasury Secretary John Snow, in an exchange with Senator Robert C. Byrd, Senate Committee on Appropriations: Subcommittee on Transportation, Treasury and General Government, Hearing on FY 2004 Appropriations for the Treasury Department (May 20, 2003).

<sup>20</sup> The dollars spent on the PDC initiative could instead have been used to fund new ACS employees. We computed the fully loaded cost of an average ACS employee at about \$75,000 (assuming GS-8, step 5). A new employee would cost somewhat less. Based on IRS expenditures of \$71 million, the number of new ACS employees that could have been funded by the PDC initiative (about 942) was multiplied by the current average dollars collected by an ACS employee per year (about \$1.5 million) to estimate the revenue that could have been garnered by ACS in one year. This translates to a return-on-investment on the average ACS employee of about 20:1. The total dollars collected by ACS reflects the collections of both fully trained and new employees who underwent training during the year. The return is generally higher for trained employees and lower for newly hired employees. If the IRS were to hire 942 new employees, the return would predictably be lower than 20:1 during the initial training period. On the other hand, the amount of appropriated funds the IRS has spent on the PDC program to date has been greater than \$71 million because infrastructure costs and certain indirect costs (e.g., the full costs TAS has incurred) have not been included. If infrastructure and all related costs were included and also applied to fund additional ACS collection personnel, the number of employees the IRS could hire would be considerably greater than 942, resulting in higher potential revenue collections.

<sup>21</sup> IRS, *Filing and Payment Compliance Advisory Council* 3 (Nov. 7, 2007).

<sup>22</sup> IRS, *Filing and Payment Compliance Advisory Council* 15 (May 1, 2007). These estimated costs exclude all infrastructure assessments.

<sup>23</sup> IRS, *Filing and Payment Compliance Advisory Council* 3 (Nov. 7, 2007).

<sup>24</sup> SB/SE response to TAS research request (Oct. 29, 2007).

<sup>25</sup> *Id.* PCA installment agreement dispositions were converted to module dispositions based on the average PCA IA modules per entities disposed of through September 2007.

has resolved 32 percent of its FY 2007 inventory by full pay and installment agreement.<sup>26</sup> If the PCAs have taken action on all the cases submitted, it appears their efforts are not as productive as IRS actions on cases.

### Case Inventory

The IRS initially described the PDC initiative to Congress as a cost efficient way to collect taxes on “easy” cases (those that can be resolved by making one or more phone calls to the taxpayer),<sup>27</sup> which the IRS would never attempt to collect anyway because it lacks the resources.<sup>28</sup> The IRS Commissioner testified before the House Ways and Means Committee that PCAs would work the “easy” cases, which the IRS attempted to identify in Phase 1.1 of the initiative.<sup>29</sup> However, the IRS subsequently removed over 30 percent of the cases identified for Phase 1.1 from the case sample because the cases were more complex than what the IRS intended to transfer to the PDC vendors.<sup>30</sup> This forced the IRS to replace these cases with older inventory, which is more challenging to collect – in other words, that are not easy to resolve.

### Searching for More Cases

The IRS has continued to struggle (in Release 1.2) to find enough easy cases to transfer to the PCAs, which has forced the IRS to explore sending other types of cases. For example, the IRS has approved sending deferred cases, which involve very low dollar amounts, to the PCAs.<sup>31</sup> While the IRS argues that this is inventory which the IRS itself probably would not work, this argument presupposes that the IRS is already working the best inventory. As noted in the National Taxpayer Advocate’s 2006 Annual Report to Congress, however, IRS data provides ample evidence to suggest the IRS may not be working its optimal inven-

<sup>26</sup> IRS, *SB/SE Collection Activity Report 5000-2* (Oct. 18, 2007). The PCAs closed only nine percent of their inventory by full pay or installment agreement, whereas the IRS closed 32 percent of its comparable inventory (FY 2007 W&I ACS full pay and installment agreement dispositions divided by sum of W&I ACS 2006 ending inventory and FY 2007 receipts). The PCAs’ resolution results may have been hampered by the typical lag between case receipt and resolution (e.g., PCAs likely had few case resolutions at the beginning of FY 2007 since their case inventory would only have been one month old).

<sup>27</sup> See Department of the Treasury, *General Explanations of the Administration’s Fiscal Year 2004 Revenue Proposals*, 99 (February 2003), stating: Many taxpayers with outstanding tax liabilities would make payment if contacted by telephone and, if necessary, offered the ability to make payment of the full amount in installments. If PCAs could perform these tasks for this group of taxpayers, without affecting any taxpayer protection, the IRS would be able to focus its resources on more complex cases and issues.

<sup>28</sup> *Private Debt Collection: Hearing Before the Subcomm. on Oversight, House Comm. on Ways and Means*, 108<sup>th</sup> Cong., 1<sup>st</sup> Sess. (May 13, 2003) (testimony of Mark W. Everson, Commissioner of Internal Revenue; IRS, *Filing and Payment Compliance* (Nov. 14, 2006).

<sup>29</sup> *Private Debt Collection: Hearing Before the Subcomm. on Oversight, House Comm. on Ways and Means*, 108<sup>th</sup> Cong., 1<sup>st</sup> Sess. (May 13, 2003) (testimony of Mark W. Everson, Commissioner of Internal Revenue).

<sup>30</sup> The IRS had to remove 15,500 cases from the initial 42,800 case inventory identified as cases that would possibly be assigned to private collectors. These cases were removed because the taxpayer had prior shelved delinquencies. IRS, *Filing & Payment Compliance Advisory Council Presentation 9* (July 31, 2006).

<sup>31</sup> IRS, *Filing and Payment Compliance Advisory Council 7* (Oct. 4, 2007). Deferred inventory are Status 23 accounts that have not been worked beyond initial collection activity because the accounts do not meet IRS tolerance levels established for active inventory. Generally, the amounts owed on these accounts are relatively low dollar. IRS, *Private Debt Collection, Interim Report on the Cost Effectiveness Study* at xxiv. IRS tolerance levels are periodically updated as a result of staffing and other workload considerations. Assigning these cases to the PCAs raises significant equity considerations: the IRS does not know if these accounts involve a high concentration of low income individuals, who may be unable to obtain representation and thus may agree to unreasonable payment alternatives in response to PCA contacts.

tory, and collecting newer, lower dollar inventory is more effective than working older, higher dollar inventory.<sup>32</sup>

In addition to expanding case inventory to include these deferred cases, the IRS is looking to ACS to supplement the low number of “easy” cases. The IRS is studying 1,500 modules to identify cases that it can remove from ACS inventory and place with the PCAs.<sup>33</sup> Thus, the IRS is now proposing to give to the PCAs the types of cases that the IRS itself is already working and could continue to work at a greater rate in the future, which is precisely the opposite of the premise on which the program was sold – namely, giving PCAs only the types of cases the IRS itself otherwise would not work.

It makes little sense for the IRS to explore expanding PCA case inventory and taking cases away from ACS when it is not yet clear how many cases the PCAs have actually worked and how successful the vendors are at locating the taxpayer and collecting the liability.<sup>34</sup> It is difficult for TAS to assess the efficiency and effectiveness of PCA activities on taxpayer accounts because the IRS has granted the PCAs extensions on the return of IRS case inventory that the PCAs have not yet resolved.<sup>35</sup>

### Cost Effectiveness Study

In response to the National Taxpayer Advocate’s 2006 Annual Report to Congress, the IRS designed a cost effectiveness study that attempts to take a more “apples-to-apples” approach than a study comparing PCA cases to IRS “next best cases.”<sup>36</sup> While this study reflects progress, it still does not make a direct apples-to-apples comparison.<sup>37</sup> The IRS is conducting two separate tests. One will compare PCA collection results with results from the IRS working the next best case (*i.e.*, the next case that ACS would work if resources were available).<sup>38</sup> The other will place inventory with the IRS that is roughly equivalent to that worked by the PCAs and will compare the collection results achieved by the two

<sup>32</sup> National Taxpayer Advocate 2006 Annual Report to Congress at 68-69.

<sup>33</sup> IRS, *Filing and Payment Compliance Advisory Council* (Nov. 7, 2007) at 7.

<sup>34</sup> IRS, *Private Debt Collection, Interim Report on the Cost Effectiveness Study* at 5. This report shows that the PCAs only collect 4.9 percent of the “unable to contact” (UTC) and “unable to locate” (UTL) cases. When considering the IRS’ UTL and UTC ending inventory for FY 2006 and new UTL/UTC cases for FY 2007, 4.7 percent were reactivated. Reactivation indicates the IRS found the taxpayer or a levy source; however, the IRS does not separately track resolution of these cases. Moreover, when considering the total IRS currently not collectible inventory (FY 2006 ending CNC inventory plus FY 2007 new CNC cases), the IRS collected full pay on an additional 6.8 percent.

<sup>35</sup> SB/SE response to TAS research request (Oct. 29, 2007). IRS, Request for Quotation, Request No. TIRNO-05-Q-00187, at 22 (¶ A.4.5). Taxpayer accounts will be automatically recalled after 12 months unless the account condition warrants continued work efforts by the Contractor assigned the case. Conditions that would warrant an extension of the placement period may include: Acceptable payment within 60 calendar days prior to recall date or approval from Contracting Officer’s Technical Representative (COTR). The IRS can request the return of a case at any time upon notice to the PCA. See also IRS, *Private Debt Collection Private Collection Agency Policy and Procedure Guide*, § 6.1. The PCAs were to begin returning the case inventory in September 2007, but the IRS granted the PCAs a seven-month extension to return the cases. IRS, SB/SE response to TAS research request (Oct. 29, 2007).

<sup>36</sup> Next best case is a term that is not clearly defined, but these are often cases that involve larger dollar amounts and are more complicated, and generally take priority over other IRS cases. National Taxpayer Advocate 2006 Annual Report to Congress 63.

<sup>37</sup> IRS, *Private Debt Collection Cost Effectiveness Study 2* (Aug. 24, 2007).

<sup>38</sup> *Id.* at 3.



approaches.<sup>39</sup> This study is the IRS's attempt to more directly compare its own collection results to those of the PCAs. However, the study has some flaws that undermine its usefulness as an apples-to-apples comparison.<sup>40</sup>

### *Inventory Placed with the PCAs*

The inventory placed with the PCAs includes cases under \$25,000 and others where the taxpayer cannot be contacted or located.<sup>41</sup> The IRS will compare these PCA cases with two separate groups of IRS cases. One group is referred to as the next best case (*i.e.*, cases that the IRS has prioritized) and usually involves high dollar balances due of up to \$100,000.<sup>42</sup> As the National Taxpayer Advocate previously stated, comparing the IRS's performance on these cases to PCA performance on its cases is not an accurate comparison.<sup>43</sup> In response to this concern, the IRS developed a second group of cases that are very similar to the cases being worked by the PCAs, such as those involving very low dollar amounts or where the taxpayer cannot be contacted. Comparing this second group to PCA cases will yield a better evaluation.<sup>44</sup> But although the cases are similar, the IRS and PCA methods of collection are not. This disparity raises questions about the validity of this study.

### *IRS and PCA Procedures*

It is difficult to consider this study a true apples-to-apples comparison when the methods used to collect the liability are different. In this test, the IRS and PCAs will work the same type of inventory. The Cost Effectiveness Study (CES) methodology, however, allows the PCAs and IRS the latitude to work these cases according to their own separate procedural guidelines.<sup>45</sup> The most significant difference is the IRS's authority to use its enforcement powers, such as placing liens and levies on taxpayer accounts and property, which the PCAs lack.<sup>46</sup> To determine the effectiveness of the IRS's own collection strategy, it is important to know whether the IRS can work PCA-type cases more effectively and efficiently than the PCAs, both with and without the IRS's full enforcement powers. Thus, for the study to accurately compare the collection results, one component of the study should limit the IRS's activities to those of the PCAs.<sup>47</sup>

<sup>39</sup> IRS, *Private Debt Collection Cost Effectiveness Study 2* (Aug. 24, 2007).

<sup>40</sup> The current data received from the Cost Effectiveness Study does not include a validated IRS control group that reflects cases more similar to PCA cases.

<sup>41</sup> IRS, *Private Debt Collection Cost Effectiveness Study 3* (Aug. 24, 2007).

<sup>42</sup> *Id.*

<sup>43</sup> National Taxpayer Advocate 2006 Annual Report to Congress 52. In this test, IRS employees will work different and more complicated cases than the PCAs. Further, the IRS employees have the option of exercising their enforcement powers. See generally IRC §§ 6321 and 6331.

<sup>44</sup> IRS, *Private Debt Collection Cost Effectiveness Study 3* (Aug. 24, 2007).

<sup>45</sup> IRS, SB/SE Response to TAS research request (Oct. 29, 2007).

<sup>46</sup> IRC §§ 6321 and 6331.

<sup>47</sup> Such a multi-faceted study would show us whether the IRS could more effectively work the PCA cases and lead to a better understanding of why and to what efforts taxpayers respond with respect to delinquent accounts, and of what constitutes a "next best case."

### *Preliminary Results from the Cost Effectiveness Study*

The Taxpayer Advocate Service requested data results from the CES for inclusion in this report. As of this writing, however, data from the IRS test groups had not been validated. In light of this lack of CES data, TAS compared PCA cases to Wage and Investment (W&I) division next best cases, which are similar to the cases being used in the CES next best case test group. The result of comparing these two groups illustrates the superiority of the IRS's collection function over the PCAs. For example, the PCAs collected full payment of tax liabilities in seven percent of its modules through FY 2007, whereas the IRS collected full payment in nine percent of its module inventory for FY 2007.<sup>48</sup> Further, PCAs enrolled taxpayers in installment agreements in three percent of its modules through FY 2007, while the IRS placed taxpayers into installment agreements in 22 percent of its module inventory for FY 2007.<sup>49</sup> It makes little sense to pay PCAs to collect tax liabilities when the IRS can do it so much better. The IRS has previously responded to this concern by stating that it would not normally work the cases referred to the PCA initiative and so any revenue raised is in addition to its normal work. However, this rationale is undermined by the IRS's recent determination to place ACS inventory (*i.e.*, cases the IRS is already working, and could continue to work at a greater rate in the future) with the PCAs.

### **Transparency of PCA Operational Plans, Training Materials, and Calling Scripts**

The laws and regulations governing federal procurement and contracting, including the protection of "proprietary information," are numerous and complex. The Trade Secrets Act,<sup>50</sup> the Freedom of Information Act,<sup>51</sup> the Procurement Integrity Act,<sup>52</sup> and the Federal Acquisition Regulation<sup>53</sup> each provide protection to what variously has been called "proprietary information," "trade secrets and commercial or financial information," "contractor bid or proposal information," or a contractor's "legitimate proprietary interest ... in data resulting from private investment." Notwithstanding this broad protection, we can find no statute or regulation that prohibits the IRS from stating in its Request for Quotation (RFQ) that successful bidders must agree to disclose certain information.

<sup>48</sup> IRS, *Filing Payment Compliance Advisory Council 5* (Nov. 11, 2007); IRS, *SB/SE Collection Activity Report 5000-2* (Oct. 2, 2006 and Oct. 18, 2007). The PCAs closed only nine percent of their inventory by full pay or installment agreement (installment agreement entity closures were converted to modules by the average number of modules per entity for PCA installment agreement cases), whereas the IRS closed 32 percent of its comparable inventory (FY 2007 W&I ACS full pay and installment agreement dispositions divided by sum of W&I ACS 2006 ending inventory and FY 2007 receipts). The PCAs' resolution results may have been hampered by the typical lag between case receipt and resolution (*e.g.*, PCAs likely had few case resolutions at the beginning of FY 2007 since their case inventory would only have been one month old). At the time of this writing, the CES had not yet validated IRS test group data. Therefore, TAS compared validated PCA test group data to W&I ACS cases actually worked in FY 2007. TAS acknowledges that comparing PCA test group data results to actual W&I ACS results is imperfect because the IRS W&I test group includes cases not currently being worked by the IRS. We anticipate that the study will provide more precise and complete data.

<sup>49</sup> IRS, SB/SE Response to TAS Research Request (Oct. 29, 2007). PCA installment agreements dispositions were converted to module dispositions based on the average PCA installment agreement modules per entities disposed of through September 2007. W&I and ACS percent of inventory closed is based on FY 2007 dispositions divided by the sum of the FY 2006 ending inventory and FY 2007 receipts.

<sup>50</sup> 18 U.S.C. § 1905.

<sup>51</sup> 5 U.S.C. § 552.

<sup>52</sup> 41 U.S.C. § 423.

<sup>53</sup> 48 C.F.R. Parts 1-53.

The IRS has an obligation to make the bulk of its policies and procedures available to the taxpaying public, and it substantially complies with this obligation.<sup>54</sup> However, the IRS has failed to ensure that the operations of the PCAs are equally transparent. The original RFQ for the PCA initiative did not specify that certain operational information must be available to the public. Consequently, the PCAs have designated almost all of their operational plans as proprietary information. Unless the IRS challenges a PCA's proprietary designation, the IRS cannot generally release such information unless the PCAs consent. The IRS and PCAs cannot be on a level playing field if the IRS is bound by the collection procedures set forth in the Internal Revenue Manual (IRM) and these procedures are transparent to the public, while the PCAs employ self-designated and unchallenged "proprietary" techniques involving taxpayer contact and communications that they refuse to disclose to the public.

The items that we believe the IRS should require the PCAs to disclose do not involve matters that are "Official Use Only," which are not disclosed by the IRS. Our focus is on those items such as instructions to staff, the content and format of taxpayer letters, and calling scripts that the IRS itself must make available in the IRM or pursuant to a Freedom of Information Act (FOIA) request. Yet by virtue of the IRS's failure to articulate in the RFQ that such information must be available for public inspection to the same extent similar information of the IRS would be publicly available, and by virtue of its failure to challenge any PCA designations of proprietary information, the IRS is affording greater protection to PCA practices than Congress has afforded to the IRS's own collection practices. Such an omission profoundly undermines taxpayer rights and tax administration.

Allowing contractors to hide their processes and procedures from public scrutiny also seems contrary to the spirit of the three Taxpayer Bills of Rights enacted by Congress.<sup>55</sup> If we expect taxpayers to work with PCAs to establish agreements to satisfy their tax liabilities, we should provide them with the same protections and opportunities to understand the collection process as we require of IRS collection employees. Such secrecy is inappropriate and dangerous for a tax system that depends on the goodwill of its taxpayers to achieve its high voluntary compliance levels.

In addition, by bargaining away taxpayer rights and hiding the PCAs' procedures behind a veil of secrecy, the IRS is effectively barring the National Taxpayer Advocate from executing her statutory function – namely, speaking up for taxpayers, not just inside the IRS, but also to Congress and to the taxpayers themselves.<sup>56</sup> If the National Taxpayer Advocate were to identify a practice that in her opinion violated taxpayer rights and the PCA designated that practice as "proprietary," the National Taxpayer Advocate, absent requesting and receiv-

<sup>54</sup> See National Taxpayer Advocate Annual Report to 2006 Congress; see generally 5 U.S.C.A. § 552.

<sup>55</sup> Pub. L. No. 100-647, 102 Stat. 3342 (1988); Pub. L. No. 104-168, 110 Stat. 1452. (1996); and Pub. L. No. 105-206, 112 Stat. 685 (1998).

<sup>56</sup> The National Taxpayer Advocate is required to provide Congress with a report discussing at least 20 of the most serious problems facing taxpayers. See IRC § 7803(c)(2)(B)(ii)(III).

ing a waiver, could not disclose such information to Congress or taxpayers without risking prosecution, fines, imprisonment, and loss of employment.<sup>57</sup>

Recently, the IRS advised us that it intended to require all IRS employees who have access to PCA proprietary information, including the National Taxpayer Advocate, to sign a nondisclosure agreement.<sup>58</sup> The IRS indicated that it would deny access to PCA proprietary information to any employee who failed to sign such an agreement. In addition, we were advised that the chief executive officers of the two PCAs under contract conditioned their participation in a meeting with the National Taxpayer Advocate upon her signing this agreement.<sup>59</sup> Although the IRS subsequently reversed its decision to require the signing of a nondisclosure agreement (opting instead to mark PCA documents as proprietary), it is not clear whether the IRS has permanently abandoned the nondisclosure agreement option. Moreover, as we discussed above, we believe the IRS has eroded the level playing field by accepting the PCAs' designation of certain information central to the protection of taxpayer rights – *e.g.*, calling scripts, letters, and training materials – as proprietary. Although the Office of the Taxpayer Advocate had previously been given access to PCA operational plans, the IRS declined to provide the Office of the Taxpayer Advocate with access to revised PCA operational plans that were submitted in April 2007.<sup>60</sup> The IRS finally provided copies on November 21, 2007, as this section of the 2007 Annual Report was being finalized. The National Taxpayer Advocate therefore has not had an opportunity to review the PCAs' operational plans in the course of preparing this assessment of the PDC program.

<sup>57</sup> Trade Secrets Act, 18 U.S.C. § 1905.

<sup>58</sup> Email from Project Director, Private Debt Collection to Senior Advisor to the National Taxpayer Advocate (Nov. 8, 2007). The nondisclosure agreement transmitted with the email indicates that proprietary information may be designated with any of 12 specified labels – “proprietary,” “trade secret(s),” “proposal information,” “commercial information,” “financial information,” “technical data,” “confidential,” “confidential business information,” “business sensitive,” “limited rights data,” “restricted rights data,” or “protected data” – as well as an unknowable number of additional labels (*i.e.*, the 12 specified labels are followed by the word “etc.”). *The draft agreement prohibits disclosure of this information whether or not the documents are marked with one of these labels and applies not just to the documents themselves but to any information “derived from” the documents as well.* The agreement cites numerous statutes and an Executive Order as authority for this protection, including the Trade Secrets Act, § 1905, Title 18, United States Code; Executive Order No. 12958; § 7211 of title 5, United States Code (governing disclosures to Congress); § 1034 of title 10, United States Code, as amended by the Military Whistleblower Protection Act (governing disclosure to Congress by members of the military); § 2302(b)(8) of title 5, United States Code, as amended by the Whistleblower Protection Act (governing disclosures of illegality, waste, fraud, abuse or public health or safety threats); the Intelligence Identities Protection Act of 1982 (50 U.S.C. § 421 et seq.) (governing disclosures that could expose confidential Government agents); and the statutes which protect against disclosure that may compromise the national security, including §§ 641, 793, 794, 798, and 952 of title 18, United States Code, and § 4(b) of the Subversive Activities Act of 1950 (50 U.S.C. § 783(b)). The agreement incorporates all the “definitions, requirements, obligations, rights, sanctions, and liabilities” created by the above Executive Order and statutes.

<sup>59</sup> The Project Director, Private Debt Collection, advised the Office of the Taxpayer Advocate in October 2007 that the CEOs of both PCAs under contract with the IRS requested a meeting with the National Taxpayer Advocate to discuss their concerns about protecting proprietary information. After the National Taxpayer Advocate expressed her willingness to hold such a meeting, the Project Director proposed that IRS PDC employees be present at the meeting and that the National Taxpayer Advocate not have her counsel (the Special Counsel to the National Taxpayer Advocate, an employee of the IRS Office of Chief Counsel) present at the meeting. Email from Project Director, Private Debt Collection, to Senior Advisor to the National Taxpayer Advocate (Oct. 24, 2007). The National Taxpayer Advocate declined both conditions. Subsequently the Project Director, Private Debt Collection advised the National Taxpayer Advocate's staff that any such meetings – which were requested by the PCAs – would be conditioned on the National Taxpayer Advocate's signing of a nondisclosure agreement. Email from Project Director, Private Debt Collection, to Senior Advisor to the National Taxpayer Advocate (Nov. 8, 2007).

<sup>60</sup> The PDC Project Office at various points during the year informed us that the operational plans had been shared with TAS, that the operational plans would not be shared with TAS unless and until the National Taxpayer Advocate signed a nondisclosure agreement, and that the plans had not been shared with TAS. In fact, the operational plans were not provided to TAS until November 21, 2007.

Further, the PDC Project Office has advised us that its “process” is to share proposed operational plans with the IRS Office of Chief Counsel to obtain legal input and then, based on Counsel’s comments, to hold meetings with the PCAs to address Counsel’s concerns.<sup>61</sup> The PDC Project Office further advised us that operational plans will only be shared with the Office of the Taxpayer Advocate after those discussions are held.<sup>62</sup> We note that, other than the position of Commissioner of Internal Revenue, the two IRS positions defined by statute are the Chief Counsel and the National Taxpayer Advocate. The PDC Program Office has not explained why it seeks input on the legal consequences of the PCAs’ plans from the Office of Chief Counsel, but it does not seek input on the taxpayer-rights consequences of the PCAs’ plans from the Office of the Taxpayer Advocate at the same time. By denying the National Taxpayer Advocate simultaneous input regarding taxpayer rights concerns and generally waiting until after the plans have been approved before sharing them, the IRS is essentially telling the National Taxpayer Advocate after the fact what arrangements have been worked out and providing her with no meaningful opportunity to improve taxpayer protections while the plans are still under negotiation.

These concerns are not abstract. While we were preparing the 2006 Annual Report to Congress, the IRS advised us that the PCAs’ operational plans and calling scripts were proprietary and therefore generally could not be released without the PCAs’ consent. We therefore wrote the report to avoid including any information that might be deemed proprietary information. However, we found this requirement disturbing because one of the principles on which the PDC initiative was predicated was the existence of a “level playing field,” meaning that rules and restrictions applicable to the IRS and its employees would apply equally to PCAs and their employees. After we raised concerns, the IRS asked the PCAs for consent to disclose the scripts. The responses were initially mixed. After our report was finalized, two PCAs provided consents. The third PCA initially offered to give consent only if the IRS agreed not to require PCA employees to refer cases to TAS immediately if the taxpayer makes such a request. TAS opposed this condition, and the IRS made clear that callers who asked to be referred to TAS must be so referred. We were informed on February 27, 2007, that the third PCA finally gave an unconditional consent.<sup>63</sup> It is unclear whether the National Taxpayer Advocate could discuss this same topic after signing the nondisclosure agreement without fear of being subject to fines and imprisonment.

We are told that the PCAs seek to keep this information secret on the grounds that it constitutes core information about business methods that, if disclosed, could reduce their competitive advantage. However, the fact that the PCAs consented to the disclosure of their calling scripts last year demonstrates that all three agencies believed the benefits of obtaining or retaining the IRS contract outweighed any harm caused by disclosure of this information.

<sup>61</sup> Email from Project Director, Private Debt Collection, to Senior Advisor to the National Taxpayer Advocate (Nov. 20, 2007).

<sup>62</sup> *Id.*

<sup>63</sup> For a general discussion of the calling scripts in question, see National Taxpayer Advocate 2006 Annual Report to Congress 60 and *IRS Private Debt Collection: Hearing Before the H. Comm. on Ways and Means*, 110<sup>th</sup> Cong. 1<sup>st</sup> Sess. (May 23, 2007) (statement of Nina E. Olson, National Taxpayer Advocate).

As noted above, the National Taxpayer Advocate is not proposing a blanket disclosure of all PCA proprietary information – or the disclosure of *any* such information without the knowledge and consent of the PCAs. The National Taxpayer Advocate is simply stating that the IRS, when it renews the existing contract or requests bids under a new contract, should include a term specifying that certain information central to assessing whether taxpayers are being treated fairly (*e.g.*, calling scripts, the text of written communications to taxpayers, and certain aspects of PCA training materials for employees working on taxpayer accounts) will not be treated as proprietary. Alternatively, the IRS could simply challenge the PCA's designation of such materials as proprietary. Since the PCAs already consented to the release of their calling scripts, we believe such a term can be included without substantially reducing the number of companies interested in handling this work.<sup>64</sup>

## Conclusion

The IRS's Private Debt Collection initiative continues to raise serious concerns for taxpayers and tax administration. Its return on investment is dismal. We now know that the PCAs are no better at locating or collecting tax liabilities than the IRS itself. The IRS's failure to require the PCAs to disclose their taxpayer-related procedures to the public and reveal them to the same extent as the IRS erodes the "level playing field" and undermines the significant taxpayer protections enacted by three Taxpayer Bills of Rights. Finally, sending the PCAs new cases that require the use of discretion and judgment, when the collection environment is not transparent, is a formula for compromising taxpayers' rights. The National Taxpayer Advocate once again calls for the initiative's repeal.<sup>65</sup> Failing repeal, the National Taxpayer Advocate calls on the IRS to demonstrate its concern for taxpayers and taxpayer rights by requiring any bidders for PCA contracts to disclose their taxpayer-contact training materials, scripts, and letters.

## IRS Comments

The IRS appreciates the National Taxpayer Advocate's continuing interest in the Private Debt Collection (PDC) program and is committed to working with the National Taxpayer Advocate to ensure taxpayer rights are protected and to identify ways to continue to improve the program. Over the past year, the IRS and National Taxpayer Advocate have worked together on addressing a number of issues such as removing all taxpayer information from the PCAs once the contract has ended, informing taxpayers of their right to opt out of the initiative and work directly with the IRS, and improving service for taxpayers with limited English proficiency. We look forward to continuing our relationship with the

<sup>64</sup> If requiring the release of this taxpayer-centric information does reduce interest on the part of PCAs in bidding for this contract, it would highlight a central flaw in outsourcing the core governmental function of tax collection – that it is not possible to outsource tax collection while maintaining the foundational premise of the "level playing field."

<sup>65</sup> See National Taxpayer 2006 Advocate Annual Report to Congress; and *IRS Private Debt Collection: Hearing Before the H. Comm. on Ways and Means*, 110<sup>th</sup> Cong. 1<sup>st</sup> Sess. (May 23, 2007) (statement of Nina E. Olson, National Taxpayer Advocate).



National Taxpayer Advocate in the future to address some of the key points outlined in her report.

While we agree that there are still areas for improvement, it should be noted that the Treasury Inspector General for Tax Administration (TIGTA) reported in its most recent audit that the IRS PDC program was effectively implemented. However, even with the successful implementation, the program will be focusing on ways to improve the current operating environment.

### PDC Implementation and Program Expectations

The implementation and management of the program has been successful. Specifically, the PDC program has several key accomplishments:

- Coverage: Through FY 2007, the program has placed 70,540 taxpayers.
- Taxpayer Satisfaction: Taxpayer satisfaction has averaged 96 percent from April 2007<sup>66</sup> to the end of FY 2007.
- Quality: Measured using the same methodology as IRS quality, PCA quality ranged from 99 to 100 percent along multiple dimensions.
- Implementation: Case placements with PCAs began on September 7, 2006, as scheduled. The IRS budgeted \$73 million for the program from its inception to FY 2007, and actual costs are under budget at \$70 million.
- Dollars Collected: Through FY 2007, the program has collected \$32.1 million. This would have otherwise gone uncollected without the PDC program.
- Minimal Opt Outs: All taxpayers selected for the PDC program have the option to opt-out of working with PCAs and work with the IRS to resolve their case. They can select this option at any time and for any reason. Through FY 2007, only 343 taxpayers have chosen this option out of 70,540 taxpayers placed with PCAs (0.5 percent).
- Oversight Reviews: The PDC program received favorable reviews by the Government Accountability Office (GAO), TIGTA, and the IRS Oversight Board. The GAO found that significant progress was made in addressing the five critical success factors and 17 related sub-factors before sending cases to PCAs. TIGTA found that the program was effectively developed and implemented. The Chairman of the IRS Oversight Board commented, *“Overall, this program seems to be working well although the board intends to continue to monitor it closely. Through this program, the IRS has found a way to reach a specific segment of taxpayers who have outstanding tax debts.”*
- Secure Taxpayer Information: To date, no instances of the misuse of taxpayer information or intentional disclosure of protected information have occurred.

<sup>66</sup> April 2007 marks the starting point from which we changed our survey methodology to include the Government Accountability Office's (GAO's) recommendations.



- Minimal Taxpayer Complaints: Only three validated penalty cases out of 70,540 taxpayer entities placed with PCAs have occurred (0.004 percent).

While we acknowledge that the revenue generated in the first year has been less than what was projected, the monies collected still offer a sizable sum that, without this program, would have gone uncollected. More importantly, the goals for quality and taxpayer satisfaction<sup>67</sup> have been surpassed by actual performance. The program has developed over 55 metrics for measuring program performance in addition to the quality and taxpayer satisfaction measures. Some metrics are unique to the program, but many were developed based on those already in existence for other IRS Collection initiatives. These measures can be used to show the program's performance across dimensions similar to those used in IRS Collection (*e.g.*, cycle time for case resolution, number of cases closed to specific statuses by the PCAs, timeliness and accuracy of PCA actions, and professionalism of PCA employees).

During the first year of implementation, PCAs worked cases that were considered to be the easiest of the inactive IRS inventory. As the PCAs gained more experience and system functionality evolved, the IRS expanded the types of inventory placed with the PCAs. This process has gone according to plan, and the IRS is currently evaluating potentially viable sources of inventory for placement with the PCAs in the future. The inventory types being explored are those that would go unworked if not assigned to the PCAs.

In evaluating the PDC program, it is important to remember why it was created. It was never designed to compete with IRS collection activity. Rather, it was designed to maximize the effectiveness of the PCA resources given their limited authority level. Accordingly, cases selected for PCA assignment are from inventories that IRS employees are not working, but are still potentially collectible.<sup>68</sup> In other words, the issue is not whether the PCAs or IRS can do a better job collecting this revenue. The issue is whether the revenue collected by PCAs goes uncollected. Given the backlog of receivables and limited IRS collection resources, the PDC program helps more taxpayers with unpaid tax liabilities meet their tax obligations. Overseeing this initiative is a role that the IRS takes very seriously, and we continue to make program decisions to protect the privacy and security of taxpayers while collecting outstanding government debt.

### Cost Effectiveness Study

The IRS continues with the implementation of the Cost Effectiveness Study. During the past year, the scope of the study was expanded to not only meet the requirements of the GAO report from which the study recommendation originated, but also to address other stakeholder concerns for an "apples to apples" comparison. In April 2007, additional test cases from the PCA inventory were placed with IRS so that the performance could be monitored and compared to that of the PCAs. The methods that the IRS utilized to work those cases are similar

<sup>67</sup> The FY 2007 goal for PCA quality was 90 percent for each dimension and actual performance resulted in a range of 99-100 percent for the different dimensions. Taxpayer satisfaction goal was 90 percent and the FY 2007 results showed 96 percent.

<sup>68</sup> Statement of Kevin M. Brown, Acting Commissioner, Internal Revenue Service; Testimony Before the House Committee on Ways and Means; May 23, 2007.

to those used by the PCAs with the primary difference being the IRS' use of enforcement tools such as liens and levies. For all other procedures, the IRS followed Internal Revenue Manual (IRM) guidance for processing the cases, with the exception of outgoing phone calls. Because of the low priority of these cases in normal operations, the IRS would likely have not made outgoing phone calls on these accounts. However, for purposes of the study, call attempts were made manually or by direct dialer campaign. Since the two organizations are inherently different, they will never have process, people, or technology that are exactly the same. What is important is that the PCAs and the IRS are given the latitude to work the cases in a manner that would yield the most cost-effective results.

A working group has been convened to begin evaluating the preliminary results of the study. This working group is comprised of IRS personnel, both within and outside of the project team, as well as employees of TAS. The purpose of the group is to evaluate the preliminary results and discuss potential calculation methodologies. The group is currently in the process of validating data used for the preliminary results of the study. The IRS values the input of TAS and looks forward to continuing this working relationship as additional results become available later in 2008.

### Transparency

The PDC program has been in existence for a little over a year. As such, the IRS is continuing to work on ways to improve the program. Questions have been raised about the transparency of the program and the information that is made available to the public, specifically related to the PCA processes and procedures, operational plans, training plans and scripts. The biggest issue is striking the balance between providing adequate information without compromising an individual company's competitive advantage.

Finding that balance is an evolving process. During this first year, any procedures, plans, and scripts submitted by the PCAs were first reviewed by the PDC project team and then comments and feedback were provided to the PCAs. The next iteration of the document was submitted to IRS Office of Chief Counsel for review and comments. Once the PCAs incorporated the IRS Counsel comments, the documents were shared with the National Taxpayer Advocate for review and comment. Based on feedback from the National Taxpayer Advocate, this process will be changed to allow for TAS feedback earlier in the process.

The issue about what information in these plans and scripts should be made public is still being discussed. However, the source document provided to the PCAs by the IRS, the PCA Policy and Procedures Guide, from which the plans and scripts are based, has been a public document for more than a year, as is the statement of work that sets the parameters of the program. The PCAs have strictly followed these source documents in developing their scripts and operating plans and those documents have been determined to comply with all program parameters. The PCAs have not been afforded any greater protections with their documentation than any other contractor for the federal government. There have been no violations of Taxpayer Bills of Rights and numerous safeguard measures have been put

into place to prevent any such occurrences. The IRS is working diligently with the Office of Chief Counsel and the National Taxpayer Advocate to identify an agreeable solution that ensures rights on all sides are protected.

In conclusion, the PDC program is part of an overall collection strategy at the IRS to match the right case with the most appropriate treatment. Using the PCAs enables cases in inactive inventories to be worked with more personal interaction than could have been achieved otherwise, given the IRS' appropriated level of resources. Aggressive oversight and management processes are in place to ensure the PCAs adhere to contract requirements and protect taxpayer rights. The PDC program reduces the number of uncollected tax liabilities while allowing the IRS to better focus on more complex tax cases and issues.

With the completion of a successful implementation year, the IRS is committed to continuing to make improvements to the program so that it performs even better in the future. The IRS has worked alongside TAS in a number of ways over this past year such as having TAS representation during Quality Assurance sessions, inviting TAS representatives to participate in IRS PDC employee training, including TAS in the development of PCA refresher training, and including TAS representatives in the Cost Effectiveness Study working group. The IRS values the partnership with, and appreciates the input received from the National Taxpayer Advocate and looks forward to continuing to work with the National Taxpayer Advocate to resolve any future issues.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate appreciates the dedicated and talented IRS employees who are working on the PDC initiative. She is concerned, however, that in attempting to justify the continuation of a failing initiative, the IRS recasts events. She finds particularly disturbing the IRS's refusal to acknowledge that the rights of taxpayers trump a private contractor's proprietary interest. We discuss this and other specific concerns below.

### PDC Implementation and Program Expectations

The National Taxpayer Advocate appreciates the positive changes made to the PDC initiative, but is disappointed at its inability to receive a return on its investment or create a level playing field between the taxpayer and the PCAs. Rather than address these two significant issues, the IRS attempts to focus on more positive aspects of the PDC initiative, but a closer analysis reveals that even these aspects of the initiative are less positive than the IRS represents.

- **Coverage:** Although the IRS has placed 70,540 taxpayer cases with the PCAs, it is not clear what the resolution rate will be since the IRS has not recalled any of the cases

placed with the PCAs and has extended the time for return.<sup>69</sup> Merely placing cases with the PCAs is not necessarily a success, especially since no resolution has been reported on the vast majority of the cases.<sup>70</sup>

- **Implementation:** The PDC initiative may be “under budget” by \$3 million using recent IRS budget estimates, but the initiative has exceeded the IRS’s original projected cost of \$15 million by over 350 percent.<sup>71</sup> Significantly, and contrary to projections made as recently as in May 2006, the expenses of the program to date exceed the revenue the program has generated.<sup>72</sup>
- **Dollars Collected:** After deducting the amount the IRS itself has directly collected and commissions paid to the PCAs, the true net revenue from PCA (non-IRS) collection activity is only \$20 million, rather than \$26 million.<sup>73</sup> This is far less than the original estimate of a minimum of \$46 million for FY 2007.<sup>74</sup>
- **Opt Out:** One possible explanation for the low opt out rate is that taxpayers are unaware of their right to exercise this option. The IRS informs taxpayers of their right to opt out only in the initial IRS letter notifying the taxpayer that the case has been assigned to a PCA. The IRS has agreed to include information regarding opt out in the letter from the PCA to the taxpayer. However, the IRS has resisted TAS’s request that taxpayers be informed of their right to opt out every step of the way, including over the phone after the taxpayer’s identity has been authenticated.

The IRS hails this initiative as a success merely because the PCAs have been able to collect some outstanding tax, even though the amount is significantly below the \$46 million projection.<sup>75</sup> The IRS indicates the small amount the PCAs did collect would remain outstanding if not for the PCAs. This reasoning is flawed on two counts. First, if the IRS applied the funds expended on PDC administration to its own ACS function, the revenue collected

<sup>69</sup> IRS, SB/SE response to TAS research request (Oct. 29, 2007). IRS, Request for Quotation, Request No. TIRNO-05-Q-00187, at 22 (¶ A.4.5). Taxpayer accounts will be automatically recalled after 12 months unless the account condition warrants continued work efforts by the Contractor assigned the case. Conditions that would warrant an extension of the placement period may include: Acceptable payment within 60 calendar days prior to recall date or approval from Contracting Officer’s Technical Representative (COTR). The IRS can request the return of a case at any time upon notice to the PCA. See also IRS, *Private Debt Collection Private Collection Agency Policy and Procedure Guide*, § 6.1. The PCAs were to begin returning the case inventory in September 2007, but the IRS granted the PCAs a seven month extension to return the cases. IRS, SB/SE response to TAS research request (Oct. 29, 2007).

<sup>70</sup> The PCAs have only resolved about 20 percent of their case inventory. This includes cases where the taxpayer full paid, entered into an installment agreement, the taxpayer was bankrupt, or decedent.

<sup>71</sup> Former Commissioner Mark Everson stated, “[my] understanding is that this would require an additional incremental investment now, something \$10 to \$15 million.” *Private Debt Collection: Hearing Before the Subcomm. on Oversight, House Comm. on Ways and Means*, 108<sup>th</sup> Cong., 1<sup>st</sup> Sess. (May 13, 2003) (testimony of Mark W. Everson, Commissioner of Internal Revenue). Congressman Earl Pomeroy stated, “I’d like to introduce into the committee record testimony elicited at a hearing four years almost to the day – May 13, 2003 – before the Oversight Committee. And as this concept was being rolled out in this particular hearing, you have then Commissioner Everson who testified thusly to our committee. ‘My understanding is that this would require an additional incremental investment now, some \$10 million to \$15 million to develop the system, because we have to work very carefully with PCAs in terms of the data they would gather.’” See *Private Debt Collection: Hearing Before the H. Comm. on Ways and Means*, 110<sup>th</sup> Cong. 1<sup>st</sup> Sess. (May 23, 2007) (statement of Rep. Earl Pomeroy).

<sup>72</sup> IRS, *Filing and Payment Compliance Advisory Council 3* (Nov. 7, 2007). The PDC initiative has only brought in \$31 million year-to-date, therefore, the initiative is still operating under a \$39 million deficit.

<sup>73</sup> IRS, *Filing and Payment Compliance Advisory Council 3* (Nov. 7, 2007).

<sup>74</sup> IRS, *Filing and Payment Compliance Advisory Council 14* (May 1, 2007).

<sup>75</sup> *Id.*

would well exceed the relatively small amount collected by the PCAs. Second, the \$31 million the PCAs have collected has not yet exceeded the cost of the PDC initiative. It makes little sense to put so many resources into an initiative that yields so little.

The IRS praises the PCAs for their performance. However, it is difficult to determine how successful this performance actually is, given the large number of unresolved cases. An accurate evaluation of PCA performance is not possible without at least these three measures:

- Taxpayer Delinquent Accounts closures per staff year;
- The length of time a taxpayer's account remains unresolved; and
- Timeliness of follow-up actions.<sup>76</sup>

Contrary to the IRS's response, the initial purpose of the PDC initiative was to have the PCAs work the "easy" cases (that could be resolved with one phone call), which the IRS itself would not have the resources to handle.<sup>77</sup> However, the pool of these easy cases is smaller than expected and has left the IRS searching for new inventory sources. The IRS is studying 1,500 modules to identify cases that it can remove from ACS inventory and place with the PCAs.<sup>78</sup> The IRS suggests the IRS is not currently working this inventory, but the cases are in ACS and may be worked, depending on the caseload of the collection site. Removing these cases from ACS is precisely the opposite of the premise on which the program was sold to Congress and the public, which was to provide the PCAs with only the types of cases the IRS itself otherwise would not pursue.

The fact that the IRS might not pursue these cases, however, does not necessarily imply that using PCAs is appropriate. The IRS must still determine the most effective way to apply its resources to collect tax liabilities. According to TAS calculations, if the IRS had allocated the projected \$71 million cost of the PDC initiative to date toward its own ACS program, it could have brought in up to \$1.4 billion, compared to the PCAs' \$31 million.<sup>79</sup> Even if the IRS applied \$7.35 million – the PDC initiative's yearly cost – to ACS,<sup>80</sup> the IRS could collect over \$146 million, far exceeding the PCAs' total. It is clearly more efficient for IRS to apply its resources (*i.e.*, taxpayer dollars) to its own collection function rather than to the PDC initiative.

<sup>76</sup> IRS, Wage & Investment Division, *Business Performance Review*.

<sup>77</sup> See Department of the Treasury, General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals, 99 (February 2003), stating: Many taxpayers with outstanding tax liabilities would make payment if contacted by telephone and, if necessary, offered the ability to make payment of the full amount in installments. If PCAs could perform these tasks for this group of taxpayers, without affecting any taxpayer protection, the IRS would be able to focus its resource on more complex cases and issues. *Private Debt Collection: Hearing Before the Subcomm. on Oversight, House Comm. on Ways and Means*, 108<sup>th</sup> Cong., 1<sup>st</sup> Sess. (May 13, 2003) (testimony of Mark W. Everson, Commissioner of Internal Revenue). The original intent of the PDC initiative was to have the private collectors work only the easy cases, thereby, ensuring they will not engage in inherently governmental activities. "PCAs would allow the IRS to focus its enforcement efforts on more complex cases and issues. Significantly, because PCAs would work the simplest and most straightforward collection cases they would enable the IRS to handle more collection cases at an earlier stage in the process - before those accounts become stale and harder to collect."

<sup>78</sup> IRS, *Filing and Payment Compliance Advisory Council 7* (Nov. 7, 2007).

<sup>79</sup> *Id.* at 3.

<sup>80</sup> *Id.* at 15. These estimated costs exclude all infrastructure assessments.

### Cost Effectiveness Study

The National Taxpayer Advocate appreciates the PDC initiative's attempt to design an apples-to-apples comparison between the PCAs and the IRS collection functions, but the attempt has not fully addressed her concerns. The IRS in its response states that “[w]hat is important is that the PCAs and the IRS are given the latitude to work the cases in a manner that would yield the most cost effective results.” The National Taxpayer Advocate disagrees with the IRS's assessment. It is also important that the IRS determine whether, if given the latitude to work these cases in a cost effective manner, the IRS will produce better results, and at less risk to taxpayers, than the PCAs. Thus, the IRS should test whether using an IRS employee in a newly designed entry-level collection position, without enforcement authority, would be as effective and cost less than the PCA initiative. The National Taxpayer Advocate has made this point repeatedly and does not find persuasive the IRS's rationale for excluding this aspect of the cost effectiveness study.

### Transparency

The National Taxpayer Advocate finds the IRS's comments unresponsive to her concerns regarding transparency. The IRS demonstrates a profound misunderstanding of its oversight role in ensuring adequate taxpayer protections in the PDC initiative. For example, in its response the IRS states, “The biggest issue is striking the balance between providing adequate information without compromising an individual company's competitive advantage.” The National Taxpayer Advocate strongly disagrees with this statement. When taxpayer protection and access to information about how taxpayers are treated by tax collectors must be balanced against the “competitive advantage” of private companies, tax administration is turned on its ear. Thus, the National Taxpayer Advocate encourages the IRS to use the opportunity of the upcoming contract negotiations to include a provision in the contract that requires PCAs to disclose proprietary information that impacts taxpayers, *i.e.*, the same disclosure requirement the IRM and FOIA place on IRS operations.

It is disappointing that IRS policy on this issue is still evolving, especially since the initiative has been operating for over a year. However, now that the IRS is renegotiating the current PCA contracts, it should ensure that the contract requires the disclosure of information and procedures that impact taxpayers. In suggesting this, we are proposing that the PCAs be held to the same disclosure standards as the IRS. This information would not include matters that are “Official Use Only,” which the IRS does not disclose, but rather items such as instructions to staff, the content and format of taxpayer letters, and calling scripts, which the IRS itself must make available in the IRM or pursuant to a FOIA request.

The IRS response seems to indicate that disclosure concerns have been addressed by the public availability of the IRS Policy and Procedure Guide and the IRS Statement of Work.<sup>81</sup> However, these documents focus on the parameters of the program between the IRS and

<sup>81</sup> IRS, *Private Debt Collection Private Collection Agency Policy and Procedure Guide*; IRS, Request for Quotation, Request No. TIRNO-05-Q-00187.

the PCAs and provide little information as to how the PCAs operate when attempting to collect tax liabilities. In fact, the National Taxpayer Advocate's 2006 Annual Report to Congress addresses concerns regarding PCA calling scripts, which the PCAs consider proprietary and are not disclosed in either the policy guide or the statement of work. It is essential that these types of documents be disclosed so that Congress and taxpayers have the same opportunity to assess PCA practices as they have to assess IRS practices.

In order for the National Taxpayer Advocate to conduct her statutory function – namely, speaking up for taxpayers – she must have an opportunity to review all PCA documents at the earliest stage possible, and certainly before negotiations are held with the PCAs about changes to those documents. Recently, the National Taxpayer Advocate had to go to great lengths to obtain the most recent PCA operational plans that were provided to the IRS in April 2007. In fact, the IRS considered withholding all PCA proprietary information, including the updated plans, from all IRS employees who needed access to the materials, including the National Taxpayer Advocate, until they signed a nondisclosure agreement.<sup>82</sup> The IRS justifies its withholding of these plans for seven months – despite repeated requests from TAS personnel – by explaining that it is following the approach it used in 2006 with respect to the first set of plans. In fact, TAS received PCA operational plans in the summer of 2006, at a time when the IRS was still in its own review process. In other words, TAS comments on PCA plans were received by the IRS at a time when the IRS was still making its own requested changes to the plans. TAS also submitted additional comments upon seeing the revised plans before the initiative began in September of 2006. It was only with the second set of plans, after the National Taxpayer Advocate's issuance of her 2006 Annual Report to Congress, that IRS withheld the operational plans from the National Taxpayer Advocate.

Finally, the IRS states that “The PCAs have strictly followed these source documents in developing their scripts and operating plans and those documents have been determined to comply with all program parameters.... There have been no violations of Taxpayer Bills of Rights....” In contrast, the National Taxpayer Advocate is able to readily review, and report to Congress on, IRS desk guides, calling scripts, and training materials. If the National Taxpayer Advocate discovered IRS practices that she believed were harmful or burdensome to taxpayers, she would raise them internally with the IRS and, if the problem persisted, she might describe them in the Annual Report to Congress. The IRS has not put forward any reasonable argument as to why taxpayers should be afforded less of an advocate for their rights when private debt collectors are used for a core governmental function.

<sup>82</sup> Email from Project Director, Private Debt Collection to Senior Advisor to the National Taxpayer Advocate (Nov. 8, 2007).



## Recommendations

The National Taxpayer Advocate encourages the IRS to adopt the following recommendations in an effort to create a more level playing field between the PCAs and taxpayers:

- Include a provision in the new or extended PCA contract that requires PCAs to disclose all materials that impact taxpayers and their contacts with PCAs, including instructions to staff, the content and format of taxpayer letters, and calling scripts;
- Recall taxpayer cases that were placed with the PCAs at the inception of the initiative so the IRS can conduct an analysis of the PCAs' success in locating taxpayers and collecting tax liabilities. These cases should be analyzed by a variety of key measures, such as cycle time for account resolution, the timeliness of taxpayer contacts, and others used by the IRS to measure to performance of ACS, which will result in a better picture of the PCAs' performance;
- Require the PCA calling scripts to inform taxpayers, after their identity has been authenticated, about their right to opt out of the PDC initiative; and
- Add a component to the Cost Effectiveness Study test that limits the IRS test group's authority to use its enforcement powers in order to determine whether IRS employees would be more effective than PCA employees in collecting outstanding tax.

## Status Update: IRS Collection Strategy

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### Responsible Officials

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division  
Richard J. Morgante, Commissioner, Wage and Investment Division

### Definition of Problem

The National Taxpayer Advocate has continually urged the IRS to employ a collection strategy that effectively and efficiently balances the goals of tax collection, taxpayer service, and tax compliance.<sup>1</sup> Accordingly, the 2006 Annual Report to Congress provided specific recommendations to assist the IRS in achieving these goals. The recommendations included the need for additional research and development of early intervention activities, consideration of more flexible collection alternatives, and more appropriate use of IRS enforcement actions, *e.g.*, regarding liens and levies.<sup>2</sup> Based on a review of fiscal year (FY) 2007 Collection program indicators, as well as the IRS's formal response to the recommendations in the 2006 Annual Report, the IRS has made little progress in addressing these issues. However, we are encouraged to note that the IRS recently agreed to establish several task forces to further explore the National Taxpayer Advocate's concerns. It is imperative the IRS continue such efforts and develop a more effective collection strategy that will better meet taxpayer needs and expectations and avoid the loss of substantial amounts of revenue.

### Analysis of Problem

#### Background

As we stated in last year's report, to maximize the effectiveness of its collection program, the IRS must recognize the role of taxpayer service within the context of enforcement and broaden its understanding of all that falls under the tax enforcement umbrella.<sup>3</sup> This taxpayer-centric mindset requires a collection strategy that includes prompt human contact with delinquent taxpayers, understanding the reasons for their non-compliance, and identifying the appropriate collection treatment for each taxpayer based on his or her individual characteristics and needs.

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<sup>1</sup> National Taxpayer Advocate 2004 Annual Report to Congress 226-245; National Taxpayer Advocate Service 2006 Annual Report to Congress 62.

<sup>2</sup> See National Taxpayer Advocate 2006 Annual Report to Congress, Most Serious Problem: *Early Intervention in IRS Collection Cases*, 62-82; Most Serious Problem: *IRS Collection Payment Alternatives*, 83-109; Most Serious Problem: *Levies*, 110-129; Most Serious Problem: *Centralized Lien Processing* 130-140; and Most Serious Problem: *Collection Issues of Low Income Taxpayers*, 141-156.

<sup>3</sup> National Taxpayer Advocate 2006 Annual Report to Congress 62; Statement of Nina E. Olson, National Taxpayer Advocate, before the United States Senate Appropriations Subcommittee on Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies (Apr. 27, 2006); Nina E. Olson, National Taxpayer Advocate, Keynote Address, American Bar Association Tax Section (May 5, 2006); Statement of Nina E. Olson, National Taxpayer Advocate, before the United States Senate Committee on Finance on The Tax Gap (July 26, 2006).

The National Taxpayer Advocate was disheartened by the IRS's initial response to the 2006 Annual Report to Congress recommendations. In many ways, the IRS failed to acknowledge or even recognize that its current approach to collection was flawed in several key areas. For example, the IRS continued to contend that existing policies governing the use of collection payment options were "reasonable and realistic." In fact, the IRS categorized its administration of the offer in compromise (OIC) program as "flexible" despite the fact that OIC receipts and accepted offers for FY 2006 represented less than half of the totals for FY 2001.<sup>4</sup> Taxpayers and practitioners also seemed to disagree with the IRS's assessment of the OIC program. In a 2006 OIC customer satisfaction survey, respondents concluded the program needed improvements in "flexibility, time required and communication of all forms"<sup>5</sup> Moreover, the IRS made these claims in spite of TAS's findings that in FY 2006 more delinquent tax dollars were reported as currently not collectible (CNC) than were collected on active balance due accounts (TDAs), installment agreements (IAs) and OICs *combined*.<sup>6</sup>

However, the National Taxpayer Advocate was later encouraged by the IRS's willingness to work more proactively with TAS on many of our concerns. The IRS and TAS subsequently held meetings that paved the way for the development of several joint task groups. The parties identified and agreed to conduct more in-depth analysis of the IRS's:

- Early intervention practices;
- Financial analysis techniques (*i.e.*, use of Allowable Living Expense (ALE) standards);
- Collection payment alternatives (*e.g.*, IAs and OICs); and
- Levies.

We are hopeful that the sincere intent of establishing these groups is to bring about meaningful and much needed changes to the IRS collection strategies that are presently not providing appropriate resolutions for many taxpayers.

To this end, the focus of our status update will be to provide a follow-up analysis of current IRS collection measures and to assess the continuing impact of the related programs on taxpayers. We will also take a closer look at how the IRS may be discouraging or turning away taxpayers who earnestly and amicably desire to resolve their tax liabilities. The IRS does so in many instances by imposing inflexible or subjective guidelines such as quickly reaching a conclusion that the taxpayer's request for a certain collection payment alternative, was made "solely to delay collection," with little regard to the taxpayer's individual situation and rights.

<sup>4</sup> For a more detailed discussion of the OIC program, see Most Serious Problem, *Offer in Compromise*, *supra*.

<sup>5</sup> IRS, SB/SE Research, *Offer in Compromise (OIC) Customer Satisfaction Survey Research Report*- Project FTL0023 (Aug. 2006).

<sup>6</sup> National Taxpayer Advocate 2006 Annual Report to Congress 31.

### Current Collection Measures Show the IRS Has Made Little Progress Over the Past Year.

In light of the specific recommendations made in the 2006 Annual Report to Congress, the following FY 2007 data suggests that the IRS is still reporting substantial revenue dollars as CNC, while the use of important collection payment options decreases:

- In FY 2007, the IRS reported over two million active balance due accounts (Taxpayer Delinquent Accounts, or TDAs) as CNC – an 18 percent increase over the same period in FY 2006.<sup>7</sup> These accounts represented \$18.2 billion in revenue – a 12 percent increase.<sup>8</sup>
- The inventories of TDAs continue to age. In FY 2007, 81 percent of all open TDAs involved tax years 2004 and prior, and 27 percent involve collection cases with three or more delinquent tax periods.<sup>9</sup> A significant volume of collectible TDAs are inactive – 34 percent reside in the IRS Collection queue.<sup>10</sup>
- In FY 2007, the number of OICs accepted by the IRS declined by 21 percent from FY 2006.<sup>11</sup> Revenue dollars accepted in OICs declined by \$54.8 million – a 19 percent decrease from the same period in FY 06.<sup>12</sup>
- The IRS continues to underutilize Partial Payment Installment Agreements (PPIA).<sup>13</sup> Through June 2007, the IRS had granted fewer than 20,000 PPIAs – which represents less than one percent of all IAs granted.<sup>14</sup>

The continued high rate of accounts placed into CNC status and the low OIC and PPIA acceptance rates raise serious concerns about the effectiveness of current IRS policies and procedures. The fact that FY 2007 TAS receipts for collection-related issues have more than kept pace with TAS's FY 2006 receipts also serves to confirm that IRS collection issues are still very much in need of attention.<sup>15</sup>

<sup>7</sup> IRS, *Collection Activity Report, Recap of Currently Not Collectible*, NO-5000-149 (Oct. 1, 2007). The Collection function uses the term “balance due” to describe open collection accounts. In this report, the term describes IRS collection accounts that remained delinquent after the IRS issued routine collection notices. In the past, these accounts were called Taxpayer Delinquent Accounts (TDAs).

<sup>8</sup> IRS, *Collection Activity Report, Recap of Currently Not Collectible*, NO-5000-149 (Oct. 1, 2007).

<sup>9</sup> IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report*, NO-5000-2 (Sept. 30, 2007).

<sup>10</sup> IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report*, NO-5000-2 (Sept. 30, 2007). The IRS Collection queue is an inventory of cases awaiting assignment to the Collection Field function. While these cases are considered “open” collection accounts, they remain inactive until assigned to a revenue officer.

<sup>11</sup> IRS, *IRS Collection Activity Report, Report of Offer in Compromise Activity*, NO-5000-108 (Oct. 1, 2007).

<sup>12</sup> *Id.*

<sup>13</sup> PPIA is a collection payment alternative for taxpayers who have the ability to make monthly installment payments but cannot fully pay their liabilities prior to the expiration of the statutory period of limitations.

<sup>14</sup> SB/SE response to TAS research request (Oct. 2, 2007); IRS, *Collection Activity Report, NO-5000-6* (Oct. 1, 2007).

<sup>15</sup> TAS Business Performance Management System (Sept. 30, 2007).

**Many IRS Collection procedures are too inflexible and appear to be designed to accept no alternative other than full payment of the delinquent tax, regardless of the taxpayer's financial circumstances**

One of the main reasons for a continued decline in collection payment alternatives is the difficulty a taxpayer experiences in trying to persuade the IRS to consider an installment agreement request or OIC. This situation can hinge on a variety of factors but the one most often cited by taxpayers and practitioners is the inflexibility of current IRS collection procedures. Prime examples are the IRS's use of its Allowable Living Expense (ALE) standards in computing a taxpayer's ability to pay his or her liability, its imposition of user fees, and its expanded use of "solely to delay collection" determinations to ward off frivolous installment agreement and OIC submissions.

***Allowable Living Expenses***

To adequately assess a taxpayer's current financial condition and ability to pay, the IRS reviews the taxpayer's monthly income and expenses, then utilizes the ALE standards to arrive at this amount.<sup>16</sup> The National Taxpayer Advocate cited the ALE as a Most Serious Problem in the 2005 Annual Report to Congress and again in the 2006 Report's discussion of collection strategy.<sup>17</sup> At a high level, our initial concerns regarding ALE focused on the IRS's application of the standards, which often leads to wrong conclusions regarding the true amount available for collection and the reasonableness of collection alternatives.<sup>18</sup> These conclusions can often be disastrous for taxpayers and the IRS because they may lead to IAs that are unrealistic (and quickly default) or to rejection of a good OIC where the IRS has no legitimate way to collect more than what the taxpayer has offered. This ultimately results in additional work for the IRS and in many cases requires TAS involvement to help taxpayers avoid financial hardship and reach an appropriate resolution.

The IRS has recently made changes, some positive, to the ALE standards. The IRS initiated an in-depth study in response to the 2005 Annual Report to Congress and provided TAS with a set of proposals in March of 2007. This led to interaction with SB/SE Collection Policy and Research to seek the most efficient means of determining an accurate picture of a taxpayer's ability to pay. As a result of these discussions, the IRS published a set of revised standards on October 1, 2007, that took into consideration some of TAS concerns.<sup>19</sup> More importantly, the IRS committed to continue to collaborate on developing standards that might better reflect taxpayers' actual living expenses and needs for self-sufficiency. This collaboration will ensure that the application of these standards does not force lower income taxpayers to remain at or below the poverty level. We are also hopeful that these

<sup>16</sup> In 1995, the IRS developed and implemented the allowable living expenses (ALE) approach to determining a taxpayer's financial ability to pay delinquent taxes. This system was designed to provide more consistency in the financial analysis determinations that serve as the basis for various collection alternatives, including IAs, OICs, CNC determinations, and enforced collection actions. RRA 98 required the IRS to prescribe guidelines to determine whether to accept an offer in compromise, which in essence codified the Service's use of the ALE. See IRC § 7122(c)(2).

<sup>17</sup> See National Taxpayer Advocate 2005 Annual Report to Congress 270-291; National Taxpayer Advocate 2006 Annual Report to Congress 83-109.

<sup>18</sup> IRC § 7122(c)(2).

<sup>19</sup> See <http://sbse.web.irs.gov/collection/AllowExp/AllowExpRedesign.htm>.

efforts will lead to a set of standards that will allow taxpayers to enter into payment alternatives with terms that are far more realistic and reasonable.

### *User Fees*

The National Taxpayer Advocate is also concerned about the associated costs many taxpayers must incur when entering into IRS payment options. These costs, or user fees, range from \$150 for the submission of an OIC to \$43, \$52, or \$105 for an installment agreement.<sup>20</sup> Although taxpayers meeting the IRS definition of low income may be exempted altogether from the OIC user fee, and are eligible for a reduced fee of \$43 for IAs, the burden falls squarely on the taxpayer to identify him or herself as “low income” to receive such relief.<sup>21</sup> Accordingly, OIC submissions have dramatically decreased since the user fee took effect in November 2003.<sup>22</sup> As we have stated in prior years as well as this year’s report, if the user fees continue to lessen demand for collection payment options, they may actually cost the government more money in foregone collections and added enforcement costs than they actually raise.

### *Solely to Delay Collection*

When taxpayers seek to resolve their tax situations through appropriate payment alternatives, the IRS should timely and fairly consider their requests. TAS has noted a disconcerting trend where the IRS has begun to enforce a concept of “solely to delay collection” when processing IA or OIC proposals. “Solely to delay collection” was born out of the IRS Restructuring and Reform Act of 1998 (RRA 98), in which Congress originally intended its use for considering the merits of an OIC submission.<sup>23</sup> The premise behind such legislation was to discourage taxpayers from forestalling impending IRS actions by simply submitting a sham OIC. In such cases, the IRS may quickly return the offer and move forward with its enforcement actions with little or no delay.<sup>24</sup> The IRS subsequently modified IA regulations in 2002 to incorporate the solely to delay concept “because the legislative history indicates that Congress intended the same restrictions on levy with respect to offers in compromise be applicable to installment agreements.”<sup>25</sup> Moreover, Congress recently granted the IRS statutory authority under IRC § 6702(b) to impose a \$5,000 penalty for any

<sup>20</sup> For a more detailed discussion of user fees and OICs, see Most Serious Problem, User Fees, *supra* and Most Serious Problem: Offers in Compromise, *supra*.

<sup>21</sup> The IRS definition of a low income taxpayer is one whose income is at or below 250 percent of the federal poverty threshold, established by HHS. To be eligible for a low income waiver of the OIC user fee, a taxpayer must complete Form 656-A, *Income Certification for Offer in Compromise Application Fee and Payment* (Feb. 2007), and submit it with their original submission of Form 656, *Offer in Compromise*. In order to obtain a reduced IA user fee of \$43, a taxpayer must complete Form 13844, *Application for Reduced User Fee for Installment Agreements*, within 30 days of written notification that the IA has been approved.

<sup>22</sup> OIC receipts have declined from 127,769 in FY 2003 to 46,270 in FY 2007. TIGTA has concluded that the OIC user fee, imposed in November 2003, is responsible for reducing OIC submissions by 28 percent. See Treasury Inspector General for Tax Administration, Ref. No. 2005-30-096, *The Implementation of the Offer in Compromise Application Fee Reduced the Volume of Offers Filed by Taxpayers at All Income Levels* (June 2005).

<sup>23</sup> H.R. Conf. Rep. No. 509, 105<sup>th</sup> Cong., 2d Sess. 288 (1998), which explained that Congress did not intend that levy would be prohibited if the IRS determined that an offer was submitted solely to delay collection. Treas. Reg. § 301.7122-1(d)(2).

<sup>24</sup> IRM 5.8.3.19.1(1) (Sept. 1, 2005).

<sup>25</sup> Treas. Reg. § 301.6331-4(a)(4) (as amended by T.D. 9027, 2003-6 I.R.B. 413).

request of an OIC, IA, Collection Due Process (CDP) hearing, or Taxpayer Assistance Order (TAO) that the IRS deems “frivolous” or that was made “to delay or impede the administration of federal income tax laws.”<sup>26</sup> Thus, the stakes for an IRS determination of an intentional taxpayer delay have been raised considerably and now include a possible financial sanction for taxpayers attempting to resolve their tax situations.

While the IRS may return an OIC or exclude a request for an IA under its solely to delay criteria, IRS guidance does not clearly define what the phrase actually means.<sup>27</sup> For example, OIC guidelines state the IRS may return an offer as solely to delay collection when a taxpayer resubmits an offer that is not “materially” different from a previous offer that was considered and either rejected with appeal rights or returned.<sup>28</sup> Installment agreement guidelines, meanwhile, make several additional distinctions:<sup>29</sup>

- There is no economic reality to the request;
- The request does not address changes requested in response to a prior request;
- The request ignores direction provided by revenue officers;
- The request is made by a taxpayer that has defaulted on prior installment agreements; or
- The request is made at a time that causes it to be classified as a request made to delay enforcement action.

Further, the examples cited in the corresponding OIC and IA technical guidance provide even less clarification. The end result is often detrimental to taxpayers. For example, when the IRS returns an OIC as solely to delay collection, the IRS retains any OIC user fee and partial payments required under the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA),<sup>30</sup> and the taxpayer cannot seek administrative review of the IRS’s decision to return the offer.<sup>31</sup> Similarly, if the IRS deems a taxpayer submitted an IA proposal solely to delay collection, the IRS may simply continue with its next intended action, leaving the taxpayer no administrative appeal rights.<sup>32</sup> The National Taxpayer Advocate has long sought applicable appeal rights for OIC returns regardless of the IRS’s reasons for the return. The same rights are necessary for IA requests as well.<sup>33</sup> The American Bar Association (ABA) Section of Taxation recently voiced similar concerns and asked the IRS to replace the solely

<sup>26</sup> IRC § 6702(b) defines a specified submission as a request for a hearing under IRC § 6320 (relating to notice and opportunity for hearing upon filing of notice of lien), or IRC § 6330 (relating to notice and opportunity for hearing before levy), and an application under IRC § 6159 (relating to agreements for payment of tax liability in installments), IRC § 7122 (relating to compromises), or IRC § 7811 (relating to Taxpayer Assistance Orders).

<sup>27</sup> See IRM 5.8.3.19 (Sept. 1, 2005); IRM 5.14.3.2 (July 12, 2005); IRM 5.19.1.5.4.10(6) (Feb. 1, 2006).

<sup>28</sup> IRM 5.8.3.19 (Sept. 1, 2005).

<sup>29</sup> IRM 5.14.3.2 (July 12, 2005).

<sup>30</sup> IRM 5.8.3.19.1(1) (Sept. 1, 2005).

<sup>31</sup> See Treas. Reg. § 301.7122-1(f)(5)(ii) (noting that “return of the offer does not constitute a rejection of the offer for purposes of this provision and does not entitle the taxpayer to appeal the matter to Appeals..”).

<sup>32</sup> IRM 5.14.3.2 (July 12, 2005); IRM 5.19.1.5.4.10(6) (Feb. 1, 2006).

<sup>33</sup> See National Taxpayer Advocate 2006 Annual Report to Congress (Key Legislative Recommendation: Improve Offer in Compromise Accessibility) 507-519.



to delay collection standard with the frivolous submission codified in IRC § 6702(b) and allow the IRS's determination of such to be subject to appeal.<sup>34</sup> The ABA stated "the 'solely to delay' standard relates to the taxpayer's intentions and is therefore inevitably imprecise."<sup>35</sup>

The National Taxpayer Advocate agrees. The IRS should abandon the solely to delay standard and focus instead on the "delay or impede tax administration standard"<sup>36</sup> that Congress enacted. Moreover, whatever standard the IRS employs, the IRS should issue clear and specific guidance to clarify what factors will cause the IRS to conclude that a taxpayer intentionally sought delay when requesting an IA or submitting an OIC. The National Taxpayer Advocate is concerned that absent such guidance, the IRS may wrongly characterize many taxpayers' compliant and willing requests for resolution and initiate enforcement actions or impose undue penalties without further consideration of the taxpayer's true intent. The National Taxpayer Advocate urges the IRS to act with restraint. In only the rarest of instances should the IRS impose the IRC § 6702(b) frivolous or delay sanction. Further, the IRS should grant taxpayers administrative appeal rights to contest an IRS rejection of a submission or resubmission, and to appeal an IRS assessment of a frivolous or delay penalty.

## Summary

The National Taxpayer Advocate is mindful of the difficulties the IRS faces when carrying out its collection strategy and properly administering the tax system, which requires a delicate balance of customer service and enforcement. The IRS must carefully assess taxpayer needs, determine the most appropriate collection option or tool to meet these needs, and ensure its actions are timely. We continue to believe that significant changes to the IRS Collection strategy are necessary to deliver an effective, balanced, and service-oriented program. We are encouraged by the IRS's recent willingness to invite and work collectively with TAS to determine the most effective and efficient means to conduct its collection activities. By better understanding the needs of its internal and external customers, the IRS can make significant headway toward fostering voluntary compliance and achieving maximum revenue.

## IRS Comments

The IRS welcomes the National Taxpayer Advocate's input regarding our continued efforts to improve the effectiveness and efficiency of our collection program, and appreciate the acknowledgment of our joint efforts. Nevertheless, we disagree with the National Taxpayer Advocate's characterization of IRS collection efforts as ineffective and do not agree that the measures you have chosen to highlight are indicative of overall performance.

<sup>34</sup> Susan Serota, *ABA Members Comment on Proposed Regs on Tax Installment Agreements*, 2007 TNT 128-17 (July 3, 2007). IRC § 6702(b) allows for a civil penalty to be imposed for various frivolous tax submissions, including IAs and OICs.

<sup>35</sup> Susan Serota, *ABA Members Comment on Proposed Regs on Tax Installment Agreements*, 2007 TNT 128-17 (July 3, 2007).

<sup>36</sup> 26 USC § 6702(b)(2)(A)(ii).

### Performance Measures

For the second year in a row Collection servicewide dispositions were up eight percent and efficiency<sup>37</sup> is projected to increase by nine percent over last year. The IRS has also seen a decline for the third year in a row of total unpaid assessments over four years old, and the percentage of inventory we are working that is less than two years old has continued to increase. These results show that we continue to focus on the currency of our inventory and have achieved productivity gains. At the same time, the percentage of Automated Collection System (ACS) and field cases resolved through installment agreements has continued to increase, showing that collection alternatives are being made available to taxpayers in increasing numbers.

The measures highlighted by the National Taxpayer Advocate do not give an accurate picture and lend themselves to invalid comparisons. In the IRS response to last year's report, we pointed out that the total number of cases placed in currently not collectible status includes a broad range of dispositions, including the automated shelving of cases to prevent their assignment ahead of higher priority cases. It also includes cases in which the taxpayer cannot be located, defunct business entities, and economic hardship cases. Most importantly, a case may be reported CNC after it has been worked by a collection employee to the point at which collection potential has been exhausted.

We point out that the comparison of dollars collected to dollars reported CNC in FY 2006 is misleading due to the different universes from which the cited figures are produced. The CNC report cited takes into account all statuses of cases, including notice status and bankruptcy cases. The dollars collected figure does not account for either of these very productive parts of the collection processes and is limited to ACS, field, and queue cases. It also does not include dollars collected on returns secured as part of nonfiler activities. Overall, servicewide collection activities result in far more dollars collected than dollars declared CNC each year.

### Availability of Collection Alternatives

While it is clear that demand has decreased in the offer in compromise program, IRS data reflects that there has been an increase in the use of collection alternatives. Partial payment installment agreements entered into in FY 2007 were about double the number granted in FY 2006. The total number of partial payment agreements is still considerably less than the IRS predicted when the authority to form these agreements was granted, but we are not in a position to say whether the number granted reflects lack of interest by taxpayers in this type of agreement, earlier resolution of cases such that full payment can be achieved within the collection statute, or some other factor. The total number of installment agreements entered into by the IRS has continued to increase year over year, and has more than offset the decline in accepted offers in compromise. Thus, use of collection payment

<sup>37</sup> Collection Efficiency Enterprise Measure (volume of collection cases disposed compared to the payroll cost of working it).

alternatives continues to increase and is trending toward more of those agreements providing for full payment. We believe that this is a very positive trend for both taxpayers and the government.

### Allowable Living Expenses

We believe that the latest revisions to the allowable living expense standards reflect significant improvements in both the accuracy and the fairness of the standards. In particular, the changes resulted in higher allowances for many low-income taxpayers and taxpayers with larger households. We do not agree that the standards are a barrier to case resolution. In more than 95 percent of agreements reached with taxpayers, the standards are not applicable because the IRS and taxpayers are able to reach agreement without the need for in-depth financial analysis. Where the standards are applied due to the size of the case or the length of time the taxpayer needs in order to achieve full payment, our experience and reviews have shown that employees deviate from the standards when appropriate. We have invited stakeholders to provide examples of situations in which deviation from the standards should be considered and will take these examples into account when revising the IRM. We look forward to working with the National Taxpayer Advocate and Research to continue to improve both the standards and their application.

### User Fees

As the National Taxpayer Advocate's report noted, the current user fee structure for installment agreements includes a reduced fee for low-income taxpayers. Because this reduction in fee was not part of the proposed regulations as initially published, and was only added to the regulations just prior to their effective date, the reduced fee was not accounted for in systems programming and could not be granted to taxpayers in an automated fashion. Taxpayers claiming the reduced fee have had to self-identify after an installment agreement is granted. Programming is expected to be in place by February 2008 that will identify low-income taxpayers at the time an installment agreement is granted, eliminating the need to self-identify for all but a handful of eligible taxpayers.

The IRS does not believe the user fee is the sole reason for the decline in offer receipts. Offer receipts have been declining since FY 2001, prior to the implementation of the user fee. Although OIC receipts have been declining since FY 2001, the rate of decline has slowed even after implementation of new policies and procedures to implement the down payment requirement mandated by TIPRA. One factor that we believe has led to the decline is the many outreach efforts we have conducted over the past few years to help educate taxpayers and taxpayer representatives about OICs. We believe that our outreach efforts have led to a better understanding of who may qualify for an OIC and have therefore been a contributing factor to the declining receipt of OICs. In addition, we recently released a revised Form 656, Offer in Compromise, which was fashioned to assist taxpayers in making an informed decision about whether they are a candidate for an offer in compromise.

### Solely to Delay Collection

The authority to return offers in compromise or proposed installment agreements submitted solely to delay collection is intended to be used with discretion. In FY 2007, offers returned as solely to delay collection accounted for only three percent of all return dispositions, and one percent of total offer case dispositions. Offers returned for this reason require the manager's concurrence and signature. Examples of situations where returning an offer as solely to delay collection is appropriate are included in the IRM and are available to IRS employees for use as guidance when making a determination to return a case as solely to delay collection. We appreciate the National Taxpayer Advocate's concern about the examples provided in the IRM and most recently have revised the language in this section to provide more clarity. The revised section is currently in clearance and is expected to be available shortly. We invite the National Taxpayer Advocate to bring to our attention any situations in which the application of this procedure may be misused.

With respect to the National Taxpayer Advocate's concern that proposed collection alternatives will be deemed frivolous under § 6702(b), we are currently working with the Office of Chief Counsel to determine situations which would be considered frivolous or reflect the desire to delay or impede the administration of federal tax law. Accordingly, we have not yet issued guidance or procedures for imposing this penalty for the submission of an offer or proposed installment agreement. We anticipate that the imposition of this penalty within these programs will be very rare and we will consider the issue of appeal rights for these penalties as the guidance and procedures are developed.

Concerning the issue of appeal rights for OICs, the majority of returns on otherwise processable offers are made because the taxpayer failed to submit the information that is necessary to properly evaluate the OIC in a timely manner or because the taxpayer is not currently in compliance with filing or payment requirements. It will benefit neither the taxpayer nor the IRS to send a case to Appeals that has not progressed to the point that a resolution can be reached. We believe that the currently established procedures to reconsider such decisions are adequate. However, as part of a recently established working group that includes representatives of TAS, we have committed to reexamining OIC return procedures to ensure that adequate safeguards are in place, along with a number of other Collection program issues.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate is disappointed that for the second year in a row the IRS has failed to acknowledge the need to improve its Collection program. We agree that the IRS has made some progress with the use of installment agreements and the recent revision of the ALE standards. However, we continue to question the manner in which the IRS approaches collection cases and tracks the performance of such activities. Our position remains that the IRS is still too slow in regard to early intervention (*i.e.*, getting involved at a time when the taxpayers are likely to have the ability to successfully resolve the tax debt problems), and overly restrictive in how it uses Collection alternatives to help resolve debts that have been allowed to pyramid (*i.e.*, accrue) with the aging.

### *Performance Measures*

As discussed in last year's Annual Report to Congress, many of the IRS's measures do not take into consideration the true age of accounts receivable. We recommended that the IRS revise or develop these measures to better reflect the age of collection accounts from the taxpayer's perspective, *i.e.*, the due date of the tax return. Based on this year's response, the IRS has not changed its methodology. Moreover, we are concerned that the IRS's comments include a number of unsupported assertions that TAS has not been able to verify. For instance, the IRS claims TDAs over four years old have declined for the third year in a row. However, our analysis found the number of TDAs involving tax years 2003 (the "four year" factor) and prior actually rose over 18 percent from FY 2006.<sup>38</sup> Thus, it would appear that current IRS overage measures actually mask the true age of the TDA inventories.

The IRS also states, "the measures highlighted by the National Taxpayer Advocate do not give an accurate picture and lend themselves to invalid comparisons." We respectfully disagree with this assertion. The dollars involved in cases reported as CNC in FY 2007 totaled more than \$18 billion, a significant increase over FY 2006. We acknowledge that this amount includes bankruptcy and notice status cases.<sup>39</sup> Nonetheless, when excluding these cases, the IRS reported \$16.3 billion of TDAs as CNC — still more than the IRS collected from TDAs, IAs (including agreements from notice cases and those established in prior years), and offers.<sup>40</sup>

Regarding the IRS's discussion of dollars collected from the notice stream, we acknowledge that the IRS collects significant additional amounts from delinquency notices. However, in this report we are focusing on taxpayers who do not voluntarily pay through the notice

<sup>38</sup> IRS, *IRS Collection Activity Report, Taxpayer Delinquent Account Cumulative Report*, NO-5000-2 (Oct. 2, 2006); IRS, *IRS Collection Activity Report, Taxpayer Delinquent Account Cumulative Report*, NO-5000-2 (Sept. 30, 2007).

<sup>39</sup> Notice status cases refer to those in which the IRS has issued one of a series of its required collection notices advising the taxpayer of his or her tax debt. The IRS has not yet assigned these cases to the IRS's Automated Collection System (ACS) or Collection Field function (*e.g.*, Revenue Officers) and thus the IRS has not yet made a personal attempt to contact the taxpayer at this stage.

<sup>40</sup> IRS, *IRS Collection Activity Report, Taxpayer Delinquent Account Cumulative Report*, NO-5000-108 (Oct. 17, 2007).

process. We also recognize that cases reported as CNC include the shelving of what IRS deems lower priority cases, unable to contact or locate cases, and bankruptcies. However, if the IRS intervened earlier in these delinquencies, the cases might well result in successful collection efforts as opposed to more uncollected dollars. Finally, although we applaud the IRS effort to secure previously unfiled returns and collect these delinquencies, we note that for FY 2007 the total net amount assessed was only about \$30 million, of which just slightly over 13 percent has been collected.<sup>41</sup>

### *Availability of Collection Alternatives*

The IRS response states that although demand has decreased in the OIC program, overall “the use of collection payment alternatives continues to increase” which “is a very positive trend for both taxpayers and the government.” The IRS bases its assessment on the annual increase in the total number of installment agreements and the slight increase in Partial Payment Installment Agreements (PPIAs) for FY 2007, and adds that the use of these options has more than offset the decline in accepted OICs. While we agree that granting more IAs is a positive step, we must point out that once again the majority of these agreements are of the streamlined variety, which generally involve smaller delinquencies that can be full paid within five years. Moreover, OICs were never meant to be replacements for installment agreements. They are primarily intended as viable alternatives to reporting collection cases as currently not collectible, or as an alternative to enforced collection actions, such as levies, seizures, and foreclosures. OICs provide opportunities for taxpayers who cannot otherwise make financial arrangements to full pay their tax debts and obtain a “fresh start” toward compliance with future filing and paying requirements, while resolving past delinquencies to the best of their abilities. The IRS’s continuing underutilization of this collection tool, in spite of the numerous opportunities to take better advantage of it, reflects an ongoing reluctance on the part of the IRS to embrace and fully utilize the “fresh start” concept. As a result, we believe both taxpayer service and revenue collections have suffered accordingly.

The use of PPIAs remains minimal at best. We note that Congress enacted PPIAs not to replace OICs but rather to provide an additional collection alternative for taxpayers who could not qualify for streamlined IAs or OICs.<sup>42</sup> As we stated earlier, the IRS requested PPIA authority to help fill this gap. Although the original projections called for PPIA revenue of \$67 million from 2005 to 2009, the IRS currently has no means of tracking how much revenue the PPIA activity has generated.<sup>43</sup> TIGTA’s recent assessment of the PPIA program concluded that “because the IRS did not initially establish an appropriate management information system to monitor and track performance of the PPIA program,

<sup>41</sup> IRS, *IRS Collection Activity Report, National Delinquent Return Activity Report for National Totals*, NO-5000-139 (Sept. 27, 2007). An estimated \$25 billion of the tax year 2001 gross tax gap is attributable to individuals who do not timely file tax returns. IRS Office of Research, *Tax Gap Map for Tax Year 2001* (Feb. 2006). For a more detailed discussion of the IRS’s Nonfiler Program, see Most Serious Problem Nonfiler Program, *supra*.

<sup>42</sup> See National Taxpayer Advocate 2001 Annual Report to Congress 210-214.

<sup>43</sup> Joint Committee on Taxation JCX-69-04, *Estimated Budget Effects of the Conference Agreement for H.R. 4520* 8 (Oct. 7, 2004).

it could not determine if the program was functioning as intended and serving taxpayers appropriately.”<sup>44</sup> Considering that for the second year in a row PPIAs account for less than one percent of all IAs granted, it is clear that this option has not produced the results the IRS specifically designed it to generate. Yet, when asked, the IRS acknowledged that it is not in a position to say why this option is not more widely used.

Practitioners and TIGTA have recently voiced their concerns regarding the underutilized OIC and PPIA options. In a September 21, 2007 letter to the IRS, Diana Thompson of the National Association of Enrolled Agents (NAEA) criticized aspects of the OIC program. She said that, “In lieu of submitting offers, we see clients either filing bankruptcy or remaining in currently not collectible status until the statute expires.”<sup>45</sup> Thus, the declining use of OICs and the minimal use of PPIAs, combined with the escalating inventories of CNC cases and those in the Collection queue, are signs that the IRS is not productively using collection payment alternatives.

### *Allowable Living Expenses*

The National Taxpayer Advocate is pleased with the IRS’s recent actions regarding ALE standards. We have cited ALE as a major concern for several years now and commend the IRS for its efforts to actively include TAS in these discussions. We are also encouraged by the IRS’s invitation to seek external stakeholders’ input. We strongly recommend that the IRS obtain input from diverse groups such as attorneys, accountants, and enrolled agents as well as those associated with Low Income Taxpayer Clinics (LITC) since ALE may harm low income taxpayers. While recent revisions to the ALE standards have been encouraging, we remain concerned that the ALE approach is not sufficiently flexible to provide for reasonable and realistic payment alternatives for many low and middle income taxpayers. We look forward to collaborating with the IRS in the coming year to develop and refine standards that best reflect taxpayers’ actual expenses and needs.

### *User Fees*

We appreciate the IRS’s efforts to rectify the problems that have resulted from the increase to IA user fees in FY 2007. The IRS expects to have programming changes in place by February 2008 to automatically identify low income taxpayers at the time an IA is granted. Such automation should significantly reduce the burden these taxpayers currently endure by having to identify themselves to the IRS.

As to the effect of the user fee on the OIC program, we agree that the fee was not the sole reason for the decline in offer receipts. We merely observed, as did TIGTA, that the fee has contributed heavily to a diminished use of the OIC program. In light of stakeholder com-

<sup>44</sup> Treasury Inspector General for Tax Administration, Ref. No. 2007-30-170, *Employees Are Not Always Ensuring That Taxpayers Pay the Maximum Amount Possible When Granting Partial Payment Installment Agreements* (Sept. 14, 2007).

<sup>45</sup> Diana Thompson, National Association of Enrolled Agents, *Enrolled Agents Group Comments on OIC Program, Administration of Installment Agreements*, TNT 188-21 (Sept. 27, 2007).



ments and National Taxpayer Advocate meetings with taxpayers and practitioners, we do not agree with the IRS's position that the decline is attributable to its outreach. A decline in gross OIC receipts could be attributable to taxpayers' better understanding of when to submit offers, but the continuing decline in the number of *accepted* offers and dollars collected from them tells a different story. Moreover, this decrease means that despite IRS outreach, good offers are declining. We continue to encourage the IRS to conduct a full-fledged study of its OIC program to determine the extent to which specific barriers, be they user fees or partial payment requirements, have lessened the usage of such a viable collection option.

### *Solely to Delay Collection*

The National Taxpayer Advocate is pleased that the IRS recognizes the need for discretion when returning OICs or denying proposed IA under the authority of solely to delay collection. The fact that the IRS has returned very few OICs for this reason is encouraging. However, we will continue to advocate for additional safeguards because the IRS's decision to return an OIC comes with a steep financial consequence to taxpayers (*i.e.*, the retention of any payments made in conjunction with the OIC) and does not afford the taxpayer any appeal rights. Moreover, as it relates to IAs, we are very troubled that the IRS has no means to determine how many IA proposals it has denied on the basis of solely to delay collection. We strongly recommend that the IRS devise a method to track such decisions to ensure that IRS personnel are using proper discretion.

We remain steadfast in our belief that the imposition of a frivolous submission penalty under IRC § 6702(b) should be rare and should not adversely affect those individuals who are voluntarily attempting to resolve their tax obligations through legitimate collection alternatives such as an IA or OIC. Thus, the National Taxpayer Advocate will continue to work with Treasury and Chief Counsel to ensure that IRC § 6702(b) is properly defined.

Finally, regarding the need for an appeals process for OICs, we respectfully disagree with the IRS's assertion that such a process would not benefit the taxpayer or the government. Although the majority of returned OIC may appear to be due to the taxpayer's failure to furnish necessary financial information or comply with all filing and payment requirements, it has been commonly noted that human error often factors into such determinations, *i.e.*, the IRS has gotten it wrong. Moreover, appeal rights are vitally important in offer return situations because the IRS retains the taxpayer's 20 percent OIC down payment. We are nevertheless encouraged by the IRS's willingness to reconsider its OIC return procedures as part of the recently established working group that includes representatives from TAS.

## Recommendations

The National Taxpayer Advocate has seen some improvement in the IRS's collection strategy over the past year but significant work remains to be done. We continue to believe that more emphasis by the IRS on providing timely service to taxpayers with tax delinquency problems, and employing more flexibility in the use of available collection payment alternatives, will enable the IRS to achieve the level of efficiency and effectiveness needed to properly serve taxpayers. In order to accomplish these goals, the IRS should:

1. Continue to explore methods to better prioritize and assign collection cases, fully recognizing the impact of elapsed time on collectibility and taxpayer service. The IRS should brief TAS on these efforts and invite TAS to participate.
2. Tailor the delivery of collection inventory to recognize the differing needs and characteristics of different types of taxpayer cases. The IRS should conduct studies, with the involvement of TAS, to identify opportunities to expedite personal contacts, where it is evident such actions will achieve mutually successful resolutions.
3. Move forward with its revision or development of program measures that accurately reflect the true age of its accounts receivables. These measures should reflect the age of collection accounts from the taxpayer's perspective, *i.e.*, the due date of the tax return.
4. Continue to assess and revise its current policies regarding the use of collection payment alternatives, *i.e.*, installment agreements, partial payment installment agreements, and offers in compromise. The IRS should set clear policy guidance, as follows: In instances involving taxpayers seeking to resolve tax delinquencies, the IRS should approve a payment option that is reasonable and realistic. TAS will continue its involvement in any task groups or studies that address IRS collection payment alternatives.
5. Continue to revise the ALE standards. TAS has committed to partner with the IRS in this venture and recommends that the IRS solicit the input of external stakeholders, particularly LITCs, for future changes.
6. Remove the "solely to delay collection" standard from all collection decisions, and instead implement the "delay or impede tax administration standard" that Congress enacted in 26 USC § 6702(b)(2)(A)(ii). Nonetheless, whatever criterion it adopts, the IRS must provide clear guidance that encourages taxpayers to resolve their outstanding tax debts and avoid potential rejections and sanctions.
7. Devise measures to track the number of IA proposals that it denies under its solely to delay collection criteria. A possible solution would be to consider the input of a transaction code to IRS computer systems when the IRS denies an IA for this reason, similar to the situation in which a taxpayer requests an abatement of a penalty and the IRS employee denies such abatement.

Grant administrative appeal rights to allow taxpayers to contest determinations of installment agreements deemed to be submitted as solely to delay collection, offers returned for any reason (including solely to delay collection), as well as IRS penalty assessments.

## Status Update: Questionable Refund Program

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### Responsible Official

Eileen Mayer, Chief, Criminal Investigation

### Definition of Problem

The IRS Questionable Refund Program (QRP) detects and prevents false refunds, and is an important part of the IRS's Revenue Protection Program. The IRS made a number of improvements to the QRP in response to the problems identified in the National Taxpayer Advocate's 2005 Annual Report to Congress.<sup>1</sup> However, problems still exist. Governance of the QRP remains within the IRS's Criminal Investigation (CI) division, even though the vast majority of the procedures are civil. The ongoing deficiencies in the program create difficulties for taxpayers and tax administration. The problems include:

- The QRP process continues to subject refund claims to multiple and unnecessary delays, resulting in additional taxpayer phone inquiries and correspondence for TAS and other IRS functions;
- IRS management reports cannot verify the number of taxpayers who should have received notification of QRP refund holds;
- Problems persist in the QRP referral process. Rejected referrals lead to additional phone calls and correspondence from taxpayers inquiring as to the status of their refunds; and
- CI's revenue protection reports are not reflective of servicewide revenue protection results, due to inaccurate referral reports, rejected returns, and refund claims allowed subsequent to the QRP process.

### Analysis of Problem

#### Background on the Questionable Refund Program (QRP)

The IRS established the QRP in 1977 to identify and investigate tax returns containing questionable entries, stop the issuance of questionable refunds, and refer criminally "fraudulent" refund schemes to CI field offices for investigation. Originally, the IRS manually reviewed returns to identify potentially questionable entries. In 1996, the IRS automated the detection process, using the Electronic Fraud Detection System (EFDS), and

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<sup>1</sup> National Taxpayer Advocate 2005 Annual Report to Congress 25.

in 2002, the IRS added data mining techniques which exponentially increased CI's capacity to screen returns.<sup>2</sup>

Many problems ensued with CI's administration of the QRP program. When EFDS identified a refund claim as questionable, CI resequenced (held) the refund for one week to allow for further review.<sup>3</sup> If CI suspected "fraud," it temporarily froze the account while it verified return entries.<sup>4</sup> The IRS did not notify taxpayers of the holds and verification of entries, or afford them the opportunity to refute the determinations. Once CI determined a return to be false, it converted temporary refund holds to permanent freezes on both the current return and on future refund claims the taxpayer filed.<sup>5</sup> By 2005, CI held almost 240,000 permanently frozen refund accounts in its inventory.<sup>6</sup>

As a result, TAS experienced a 400 percent increase in its QRP inventory between 2002 and 2005.<sup>7</sup> Further, TAS studied its own inventory of QRP refunds that CI had frozen. TAS discovered that more than 66 percent of the taxpayers received a full refund, and about 80 percent received at least a partial refund. These findings raised concerns regarding the QRP processes.<sup>8</sup> The study also revealed a significant number of other problems warranting immediate attention. In response, the National Taxpayer Advocate identified the QRP as a Most Serious Problem in the 2005 Annual Report to Congress (ARC) and addressed it again in the 2006 Annual Report to Congress as a status update.<sup>9</sup>

### QRP Changes Resulting from the National Taxpayer Advocate's Concerns

In response to the National Taxpayer Advocate's concerns, the IRS instituted the following changes in an attempt to improve the administration of the QRP program:

- Establishing a Pre-Refund Executive Steering Committee to provide strategic guidance on policy, process, and technology improvements as they related to the Pre-Refund Program Office (PRPO);

<sup>2</sup> The Electronic Fraud Detection System (EFDS) was developed to support the Questionable Refund Program. It is the primary information system that enables CI to cull millions of tax returns by computer driven search techniques. CI's scanning process also includes data mining, which is the application of database technology and techniques to uncover hidden patterns and subtle relationships in data.

<sup>3</sup> Resequencing automatically delays the issuance of the refund for a certain number of weeks, as programmed. In processing year 2005, the IRS resequenced returns for one week, or one processing cycle. Manual review occurs when CI compares return entries and characteristics to determine if the entries require verification. Verification is the process by which CI contacts the employer to verify reported income and withholding.

<sup>4</sup> The National Taxpayer Advocate previously cited CI's misuse of the words "fraud and fraudulent", when they applied to taxpayer returns before CI met either the burden of proof for a civil matter (*i.e.*, "clear and convincing evidence") or a criminal case (*i.e.*, "beyond a reasonable doubt"). Unfortunately, CI continues to misidentify taxpayers' refund returns found within the QRP. In its internal reports, CI has begun using the term "bad" as a replacement for its former term "fraudulent." Until either burden of proof (civil or criminal) has been met, however, taxpayers' unsupported return entries simply remain "questionable."

<sup>5</sup> After CI determined that a refund claim was potentially false, it put a permanent freeze ("Z" Freeze) on the taxpayer's account, which only CI could remove. This action froze the current refund claim, and all future refund claims, until the taxpayer had filed a number of compliant returns as determined by CI.

<sup>6</sup> Treasury Inspector General for Tax Administration, Ref. No. 2007-10-076, *Actions Have Been Taken to Address Deficiencies in the Questionable Refund Program; However, Many Concerns Remain, with Millions of Dollars at Risk* 11 (May 2007).

<sup>7</sup> National Taxpayer Advocate 2005 Annual Report to Congress vol. 2, at 1.

<sup>8</sup> *Id.* at 2. In the study, fraud was not considered to be present if the taxpayer received a *full* refund.

<sup>9</sup> National Taxpayer Advocate 2005 Annual Report to Congress 25; National Taxpayer Advocate 2006 Annual Report to Congress 408.

- Notifying taxpayers of the refund hold and the opportunity to submit documentation when CI cannot verify return entries;
- Implementing a systemic mechanism to automatically release frozen refunds at 70 days unless CI has taken further actions on the case;
- Eliminating the practice of automatically freezing future refund claims; and
- Referring cases to the civil functions when CI cannot verify return entries or the taxpayer does not submit documentation establishing entitlement to the refund.<sup>10</sup>

### The National Taxpayer Advocate's Continuing Concerns

#### *The IRS Continues to Oversee its QRP Criminally — Rather than in its Civil Functions — Creating an “Inverted-Funnel Effect.”*

Very few questionable refunds meet the criteria necessary for the IRS's criminal function to continue investigating a refund claim. However, the IRS continues to filter all refunds through its Criminal Investigation Division. The chart below illustrates the “inverted funnel” through which the entire annual volume of individual refund returns must first trickle, and that the IRS uses to identify and prosecute a miniscule number of criminal cases:

<sup>10</sup> If CI concludes that a return verifies as “bad” (i.e., wage and withholding information cannot be verified by third-party contact), and the *only* issues in question are the wage and withholding, CI will issue a letter (CP05A) to the taxpayer, giving the taxpayer an opportunity to submit documentation to substantiate the wage and withholding information. CI allows the taxpayer 45 days to respond. If the taxpayer does not respond, or if the documentation submitted does not substantiate the return entries, CI at the conclusion of 45 days refers the case to Accounts Management (AM) to fully or partially disallow the refund claim, send the appropriate disallowance letter (105C for full disallowance and 106C for partial disallowance), and advise the taxpayer of his or her right for judicial appeal. If there are other issues present on the return besides the wage and withholding, (EITC, refundable credits, etc.) and the return verifies “bad”, CI will refer the return to Exam for issuance of the initial contact letter (Letter 566H for 2006 and prior tax years, and 566E for the 2007 tax year) to start the audit process. If the taxpayer cannot establish entitlement to the refund, the case will go through deficiency procedures (IRC §6212 through §6215) pursuant to which the taxpayer receives a Statutory Notice of Deficiency, which allows 90 days to file a petition with the U.S. Tax Court. For example: If withholding claimed on the return does not match IRS records and the employer verifies a lesser amount was withheld, the case will be referred to AM, which will issue a disallowance letter. The letter will advise the taxpayer that he or she has two years from the date of the letter to file suit with the U.S. District Court or the U.S. Claims Court. If the same return reported both withholding and Earned Income Tax Credit (EITC), the case would be referred to Exam to begin an audit. If the taxpayer could not prove entitlement, the IRS would ultimately send a notice of deficiency to inform the taxpayer that he or she has 90 days to petition the U.S. Tax Court.

**Table 1.29.1, The QRP “Inverted-Funnel”**

Form 1040 Series Returns	Total Volume (Rounded) <sup>11</sup>
2007 Individual refund returns received <sup>12</sup>	102,000,000
2007 EFDS-identified returns (including prisoner returns) requiring manual review <sup>13</sup>	468,000
2007 Information documents sent for verification <sup>14</sup>	301,000
2007 CI verified returns as potentially false	201,000
2007 Returns referred to the “civil functions” <sup>15</sup>	124,000
2007 “Category I” kept in CI inventory <sup>16</sup>	18,000
2007 CI cases criminally indicted <sup>17</sup>	164

As the table illustrates, the IRS processed approximately 102 million refund requests during the 2007 processing year through its specialized criminal function. The QRP process creates bottlenecks at the beginning of the process, as the IRS forces millions of legitimate claims through a relatively small organization designed principally for criminal investigation, rather than through its larger civil functions. Thus, the present QRP design inverts the logical direction of flow through the “small end” of its refund processing funnel.

### *Uprighting the Funnel — Shifting QRP to the Civil Functions with Oversight by the Pre-Refund Program Office*

The IRS’s civil functions, Examination and Accounts Management (AM), process the overwhelming majority of refund returns containing questionable entries. If the IRS shifted responsibility for the QRP to the PRPO, the funnel’s flow would be righted. The PRPO would assume responsibility for overseeing the program by scanning, verifying, and assigning QRP cases to the proper civil functions for processing based on a pre-established hierarchy of rules. Each function would be responsible for developing its own selection rules and working with the other functions (including CI) to determine the appropriate hierarchy for these rules. Moreover, the civil functions would refer the relatively small number of potentially criminal refund claims to CI, thus better aligning the workflow within the IRS organizational structure.

<sup>11</sup> CI tracks QRP volumes on a calendar year basis. Figures in this table refer to QRP measurements that are cumulative for calendar year 2007 through August 31, 2007. Each number is not necessarily a sub-set of the previous number. QRP Workload Comparison Summary (Aug. 31, 2007), CI response to TAS research request (July 26, 2007); *Statistical Data-Questionable Refund Program (QRP): FY2005-196, FY2006-157, and FY2007-164*, E-mail from CI Senior Analyst (Oct. 5, 2007).

<sup>12</sup> IRS, *SOI Tax Stats-Filing Season Statistics/Taxpayer Usage Study*, at <http://www.irs.gov/taxstats/article/0,,id=96629,00.html>.

<sup>13</sup> EFDS identified 467,815 refunds as questionable.

<sup>14</sup> Manual review by CI employees, together with additional referrals, further resulted in 301,143 information documents (*i.e.*, Forms W-2 and 1099) needing verification by a third party. A return may contain more than one information document.

<sup>15</sup> This figure refers to the number of returns that CI referred to IRS civil functions for further processing, after CI completed all of its processes (scanning, manual review, and verification).

<sup>16</sup> The IRS authorizes CI to adjust only a small number of specific accounts. All other accounts require referral to either AM or Exam. E-mail from CI Senior Analyst (Oct. 5, 2007).

<sup>17</sup> A CI case in this context is the criminal case against the individual. A single case may involve multiple instances of false return filings. The number 164 is taken from *Statistical Data-Questionable Refund Program (QRP)* at <http://www.irs.gov/compliance/enforcement/article/0,,id=118221,00.html>.



### *CI Freezes More Refunds Than Can Be Verified Within the Allotted Timeframe*

After initial selection of a potentially false refund claim by EFDS, CI automatically resequences (delays) the refund for up to 14 days. During that time, CI personnel manually review return entries and characteristics to determine if the refund claim requires third-party verification.<sup>18</sup> In 2007, CI released approximately 36 percent of EFDS selected returns, or 167,000 legitimate refund claims, after holding them for up to 14 days for manual review.<sup>19</sup> The National Taxpayer Advocate agreed to CI's practice of automatically resequencing returns for 14 days (up from seven days) only for processing year 2007. For 2008 and subsequent processing years, we believe CI should return to the seven-day timeframe, thereby releasing legitimate refunds more quickly.

### *QRP Processes Cause Multiple Refund Delays*

The QRP subjects refund claims to multiple reviews and delays. During the resequencing period of 14 days, CI will perform a manual review and start the process of verifying entries on the return, if necessary. If CI cannot complete the verification within the 14 days, it freezes the refund for up to 70 additional days. After the 70 days, CI must either act on the return itself or refer the refund claims to the civil functions for resolution.<sup>20</sup> After this combined period of delays, still more time accumulates during processing in the civil functions before the IRS ultimately resolves the claim.<sup>21</sup> These multiple delays result in additional calls and correspondence from taxpayers questioning the status of their refunds.

### *Taxpayer Notification of QRP Delays Cannot be Verified*

Once CI determines return entries need verification, it freezes the refund for up to an additional 70 days by placing a "P-" freeze on a taxpayer's account via the IRS's Integrated Data Retrieval System (IDRS). The "P-" freeze triggers the IRS master file to generate Notice CP05, which informs the taxpayer of the QRP refund hold. In processing year 2007, CI identified over 301,000 taxpayer information documents as needing further verification, but IRS systemic processes generated fewer than 200,000 CP05 notices to taxpayers to

<sup>18</sup> In processing year 2007, CI automatically resequenced (delayed) the issuance of the refund for up to 14 days to allow for manual review.

<sup>19</sup> In processing year 2007, EFDS flagged 467,815 returns. After manual review, 301,143 were held for verification and 166,672, or 36 percent, were released. CI response to TAS research request (July 26, 2007); QRP Workload Comparison Summary (Aug. 31, 2007).

<sup>20</sup> The 70 day ceiling allows CI time to verify information documents with the employer. If the refund is not to be released, CI will receive and review documentation in response to the CP05A request that IRS sent to the taxpayer, enter return information into the Scheme Tracking and Reporting System (STARS), and refer claims to the civil functions.

<sup>21</sup> When AM employees receive a refund claim from CI, they adjust the taxpayer's account to show the disallowance, and send the notice of claim disallowance (letter 105C or 106C) to the taxpayer. AM strives to complete the process within 30 days. Thus, up to approximately 16 weeks will pass before the claim is resolved (*i.e.*, resequencing takes up to 14 days, verification and CI suspense take up to 70 days, and AM processing takes up to 30 days). When CI refers a refund claim to Exam, the processing time is even longer, as the case must go through deficiency procedures. Exam must establish the case on AIMS, send the Initial Contact Letter (ICL), issue the Statutory Notice of Deficiency (SNOD), and process the adjustment to the taxpayer's account. Adding up to two weeks for resequencing, the process takes up to approximately 29 weeks (*i.e.*, establishing of an account on AIMS takes up to 21 days, sending the ICL takes up to 45 days, issuing the SNOD takes up to 105 days (90 days plus 15 for purging), and adjusting the account takes up to 21 days, for a total of 192 days). The average Exam cycle time in FY 2006 was 190 days for EITC and 139 days for non-EITC refund claims. IRS, *Wage & Investment Business Performance Review 13* (June 21, 2007).

inform them of the additional 70-day delay.<sup>22</sup> The inability to reconcile these two numbers indicates the IRS lacks a robust management information system that can monitor the QRP workflow during the transfer process to the civil function and notify to the taxpayer of the QRP refund hold.<sup>23</sup> CI representatives have indicated the difference of 100,000 returns in the figures may be misleading because many factors might have contributed to the discrepancy.<sup>24</sup> However while CI's explanations have merit, CI does not maintain records to support all of the component factors.

### *Problematic Referral Process Creates QRP Rejects and Lost Cases*

Problems continue within the IRS process designed to refer (transfer) cases to both the Examination and Accounts Management functions. The civil functions rejected almost 22,000 cases referred by CI in processing year 2007 due to conditions preventing the functions from processing them.<sup>25</sup>

Rejected QRP cases present a major tracking problem for IRS personnel as well as for taxpayers inquiring about delayed refunds.<sup>26</sup> For example, when Exam rejects a referral and sends the case back to CI, Exam does not open the case on the Audit Information Management System (AIMS), and the case is not reflected in Exam's inventory.<sup>27</sup> However, the IDRS control base will still indicate that CI has referred the case to Exam.<sup>28</sup> Therefore, when a taxpayer calls to inquire about his or her refund, the IRS employee reviewing the IDRS control base cannot help the taxpayer because the employee cannot locate the return.

<sup>22</sup> The IRS reports that 199,975 CP05 notices were issued as of Aug. 31, 2007. IRS, Office of Notice Gatekeeper, *Notice Counts* (Aug. 31, 2007). CI verified 301,143 returns per QRP Workload Comparison Summary (Aug. 31, 2007); CI Response to TAS research request (July 26, 2007).

<sup>23</sup> For an in-depth discussion of the National Taxpayer Advocate's concerns with respect to the taxpayer's right of due process in these cases, see National Taxpayer Advocate 2005 Annual Report to Congress 50.

<sup>24</sup> CI suggested that some of the factors that might have contributed to the discrepancy include: (1) CI completed the verification process within the 14 days on approximately 35,000 information documents and released the refunds, negating the need for a "P-" freeze (input of "P-" freeze automatically generates issuance of CP05); (2) returns and Forms W-2 are sent to verification after the refund has been released, so CP05s would not have been issued; (3) the 301,143 figure reflects the number of information documents that CI verified with employers but the number of documents may be greater than the number of taxpayer returns, as a return may include multiple information documents; and (4) CI reports that there is a difference of 2-3 weeks between the time CI inputs the "P-" freeze and the notices are displayed on the gatekeeper website. CI response to TAS QRP Status Update (Dec. 4, 2007), meeting between representatives of CI and TAS (Nov. 29, 2007).

<sup>25</sup> W&I response to TAS research request (Aug. 24 2007), Accounts Management response to TAS research request (Aug. 30, 2007). CI disagrees with this volume and reports that total rejects for 2007 were approximately 11,000 (10,986). CI response to TAS QRP Status Update (Dec. 4, 2007).

<sup>26</sup> Cases are rejected because various conditions on the taxpayer's account preclude that function from working the case. Examples of these conditions include various account freezes, open or prior closed audits, expired or imminent statute, released refund, and various credits and adjustments. Cases also reject because the CI file may contain duplicates of a case, information mismatches, etc.

<sup>27</sup> The Audit Information Management System (AIMS) provides inventory and activity controls of active Exam cases.

<sup>28</sup> The Integrated Data Retrieval System (IDRS) manages data retrieved from the Master File allowing IRS employees to take specific actions on taxpayer account issues, track status, and post transaction updates back to the Master File. It provides for systemic review of case status and notice issuance.

Compounding the problem further, CI during early 2007 temporarily suspended the quality check it previously performed before referring QRP cases to civil functions.<sup>29</sup> CI reports that it has automated the quality check for processing year 2008.<sup>30</sup>

### *Accuracy of Revenue Protection Reports*

CI's revenue protection statistics may include refunds released subsequent to the QRP process. For example, if the taxpayer successfully refutes the refund disallowance after CI refers a claim to Exam, the refund will be released.<sup>31</sup> During the 2007 processing year, CI reported it had stopped 160,000 refunds valued at over \$1 billion.<sup>32</sup> However, CI's figures include refund amounts from returns it referred to Exam — amounts that may have been released when the taxpayer verified return entries during an audit or during Exam's Audit Reconsideration process.<sup>33</sup>

In addition, CI's count of cases referred to the civil functions does not agree with the records of the cases maintained by the functions. Many times during the referral process, cases are duplicated, thereby inflating the count. This was one of the failures the IRS identified during a baseline study of the QRP process.<sup>34</sup>

### *Joint Research Study Conducted by TAS and CI*

In both the 2005 and 2006 Annual Reports to Congress, in an effort to improve QRP filters, avoid pulling compliant taxpayers into the QRP process, and minimize the delay of legitimate refunds, the National Taxpayer Advocate recommended that CI conduct a research study of the QRP returns that CI has flagged as "potentially fraudulent." CI has agreed to work with TAS to conduct such a study to determine the accuracy of CI's determination of "potentially fraudulent" or "bad" returns that CI entered into its Scheme Tracking and Reporting System (STARS).

## Summary

CI, the criminal division of the IRS, controls the QRP program even though it refers the vast majority of cases to the IRS's civil functions for ultimate resolution. The National Taxpayer Advocate applauds CI for the improvements it has made in the administration of the QRP program since 2005. However, problems within the QRP process continue to present significant obstacles for taxpayers claiming legitimate refunds.

<sup>29</sup> CI reports that the quality review process was temporarily suspended as it conducted a study to determine impact of the quality review process. CI response to TAS QRP Status Update (Dec. 4, 2007).

<sup>30</sup> CI has an automated quality review tool that identifies certain fields that are incomplete, rendering the case not referable to the civil functions. CI suspended the check as per a CI Management Guidance Memorandum. IRS, *Pre-Refund Program Business Process Baseline Briefing* vol. 1 52 (July 17, 2007).

<sup>31</sup> Various venues exist for refuting refund claims, including Exam's audit and audit reconsideration processes.

<sup>32</sup> QRP Workload Comparison Summary (Aug. 31, 2007); CI response to TAS research request (July 26, 2007).

<sup>33</sup> CI response to TAS research request (July 26, 2007).

<sup>34</sup> IRS, *Pre-Refund Program Office, Business Process Baseline Modeling*, vol.1 58 (July 17, 2007).

The National Taxpayer Advocate strongly urges the IRS to transfer responsibility for the QRP from CI to the Pre Refund Program Office, establish a hierarchy of procedures to fix the structural problems within the QRP, and ensure that the reporting of revenue protection is accurate.

### IRS Comments

The IRS appreciates the National Taxpayer Advocate's acknowledgment of the significant improvements made to the QRP since 2005. For the 2008 filing season, the IRS continues to make improvements to the process of identifying and stopping questionable refunds and has other process improvements planned. These include refinements to the data-mining criteria, cross-functional planning and analysis to consolidate pre refund processes, and automation of the referral process.

### Data Mining Refinements

In the 2007 processing year, there were significant improvements to the data mining model that resulted in over \$1.5 billion dollars in refunds stopped. In consultation with the National Taxpayer Advocate, the data model was improved. The most notable change was incorporating verified "non fraud" in the training dataset. This change contributed to a 67 percent reduction in the "false positive" rate so that a significantly lower percentage of non fraud taxpayers were impacted by a delay due to the QRP.

### QRP Oversight

The IRS acknowledges the National Taxpayer Advocate's concerns that the QRP program continues to reside within CI. In 2007, the IRS began work to address this concern, with the ultimate goal to consolidate processes in a timely and efficient manner within the Wage & Investment (W&I) Operating Division. The actions that have been taken, and will be taken, are:

- The establishment of the Pre-Refund Office within W&I. The Pre-Refund Office's goal is to analyze all current pre-refund processes Servicewide and consolidate those processes into one area within W&I.
- CI is conducting an interim study to look at current Fraud Detection Center (FDC) processes and identify work currently residing within the CI FDCs that could be realigned to W&I within a short time period. The ultimate goal of this study is to determine which work and associated resources should move to the W&I during 2009.
- CI Concept of Operations (CONOPS) group is currently identifying the future of FDC operations. The CONOPS plan is the future vision of Refund Crimes and the FDCs and focuses on activities directly related to CI enforcement, such as scheme development and field office referrals/coordination.

### QRP “Inverted Funnel” Table

In 2007, CI criminally indicted 164 QRP cases. However, it should be noted that those 164 investigations involved 13,368 individual returns.

### QRP Workload Transfer Process

The QRP subjects refund claims to legitimate and necessary review to protect the integrity of the tax system against those who would attack it. The refund returns that are subject to review by the QRP are less than  $\frac{1}{2}$  of one percent of all refund returns received by the IRS.

On average, CI verifies the return as a legitimate claim or as a “potentially fraudulent” claim within 14 days (70 percent are verified within the initial resequencing period). CI completes 89 percent of all verifications within 35 days. To further clarify, CI must identify the return, verify the refund claim through employment verification and refer the case to the civil function for resolution within the goal of 70 days. CI does not wait 70 days and then make the referral.

Although the notice of claims disallowance and Statutory Notice of Deficiency letters increase the number of days before the IRS completely resolves a claim, these procedures are designed to help the taxpayer when they disagree with the assessment. While the entire process may take several months, the taxpayer is notified several times throughout the process. When a taxpayer inquires about his or her refund, CI sends a notification further explaining the status of the refund. According to the Taxpayer Advocate Management Information System, the number of Operations Assistance Requests (OARs) this year has been reduced from 2006 by approximately 47 percent. It is anticipated that future automation enhancements will further decrease the length of the process.

### Automated Referral Generation

The IRS is automating the referral process between CI and the civil divisions for the 2008 processing year. Many of these changes are based on automation of segments of last year’s referral process in EFDS, and through interfaces between EFDS and the EITC program’s Dependent Database (DDB).

In 2008, CI Refund Crimes will be responsible for the generation and transfer of false refund referrals to the Account Management (AM) function and the W&I and Small Business/Small Enterprise (SB/SE) examination functions. The scope of the referral transfer covers the treatment of false returns from verification of false income documents to delivery and acceptance of referrals by AM and W&I/SBSE examination. This process will ensure that valid referrals are timely and efficiently received and worked by examination and AM.

The enhancements, changes, and improvements made to the QRP will reduce unnecessary hardships for taxpayers while at the time improve the IRS’s ability to identify and stop questionable refunds.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate acknowledges CI's and the IRS's efforts to improve the QRP since the 2005 ARC first spotlighted serious deficiencies within the program. The operational improvements are noteworthy. Moreover, CI and the IRS also merit praise for their commitment to transitioning oversight of the QRP to the W&I (civil) operating division.

### *Data Mining Refinements*

While CI cites a 67 percent reduction in taxpayer refund delays caused through its "false positive" selections, work remains, nonetheless, for the IRS to further reduce the volume of legitimate taxpayer refunds that it inappropriately delays through the current data mining process. In fiscal year 2007, CI-related cases—the vast majority of which are QRP cases—still ranked among the "Top 5" reasons that taxpayers sought TAS assistance.<sup>35</sup>

### *QRP Oversight*

We commend the IRS for establishing the Pre-Refund Office in 2007, and for publicly stating its intention to move program oversight to that office. However, the IRS must continue to take steps to ensure the expeditious transition of QRP oversight. Once in place, the centralized Pre-Refund Office should supervise and coordinate systems improvements, analyze cross-functional resources in CI, Examination and Accounts Management, and develop accurate reports showing actual dollar amounts of "protected" revenue.<sup>36</sup> However, TAS is concerned that the limited authority provided to the Pre-Refund Office may hinder future QRP improvements.

For example, the IRS cited in its response an "...interim study to look at current Fraud Detection Center processes and identify work...that could be realigned to W&I...during 2009." An independent group (not part of the Pre-Refund Office) is overseeing the cited study, and TAS is concerned that the group may potentially select a product unsuitable to the needs of each impacted function (*i.e.*, Exam, CI, and AM).<sup>37</sup> Therefore, TAS encourages CI to partner with the Pre-Refund Office in this study and perform sufficient research before implementing any significant changes to the QRP. TAS will remain actively involved in the collaborative improvement efforts made between CI and the Pre-Refund Office.

### *QRP "Inverted Funnel" Table*

Due to the nature of the criminal justice system, the IRS commonly elects to pursue criminal offenders who have filed multiple fraudulent returns to increase its chances for

<sup>35</sup> IRS, *Business Performance Management System (BPMS), TAS Regular Receipts by BOD Core Issues, by Criteria Code, FY 2006 and FY 2007 cumulative receipts*, as viewed on December 21, 2007.

<sup>36</sup> NOTE: CI may accurately state that it "stopped" \$1.5 billion using its present reporting methods, but—due to its present reporting limitations—it cannot accurately report the same figure as "protected" revenue. That figure is unknown.

<sup>37</sup> NOTE: The CI Concept of Operation (CONOPS) Study Group is internal to CI.

a successful prosecution. Therefore, 164 QRP indictments may have involved over 13,000 actual tax returns. However, even if the larger number of refund returns is considered, when compared to the entire volume of refund returns filed in 2007 (102 million), the result reflects criminal indictments for less than 2/100<sup>ths</sup> of one percent. The point remains: the vast majority of questionable refund work involves *civil* matters, and the IRS should redesign the process accordingly.<sup>38</sup>

### *QRP Workload Transfer Process*

CI improvements have reduced the volume of QRP cases requiring TAS to generate OARs back to CI for case resolution. However, as previously stated, CI cases still ranks among the “Top 5” most common issues in TAS’s inventory. Additionally, TAS urges the IRS to reduce the initial verification period from 14 days down to seven days.

### *Automated Referral Generation*

While future automation may further decrease delays experienced by taxpayers during the QRP process, TAS encourages the Pre-Refund Office to increase its involvement (and oversight) immediately, including the proper testing of future automated systems prior to their implementation. Testing should include proper tracking measurements for the time spent in each function of the process. Ideally, however, with a proper redesign of the QRP process by the Pre-Refund Office, the number of functions or personnel that must hand off cases can be greatly reduced in the future – minimizing delays through one-stop refund analysis and processing, and maximizing voluntary compliance.

## Recommendations

The National Taxpayer Advocate recommends that the IRS take the following steps in connection with the QRP:

- Expediently transfer primary responsibility for the QRP program to the PRPO office. PRPO should implement a distribution system to refer cases to the appropriate pre-refund compliance operations for resolution. CI should remain involved, but its emphasis should be limited to criminal matters and schemes.
- Reduce the automatic refund resequencing of 14 days (two IDRS processing cycles) to seven days (one IDRS processing cycle). The IRS must also ensure that it notifies all taxpayers of refunds that it freezes beyond the initial resequencing period.
- Establish a goal of improving its pre-refund case screening criteria, including all available databases such as EFDS, Dependent Data Base (DDb) and the National Directory of New Hires (NDNH) (from the Department of Health and Human Services (HHS)).

<sup>38</sup> IRS, *SOI Tax Stats-Filing Season Statistics/Taxpayer Usage Study*, at <http://www.irs.gov/taxstats/article/0,,id=96629,00.html>.