NATIONAL TAXPAYER ADVOCATE

2009 Annual Report to Congress

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NATIONAL TAXPAYER ADVOCATE

2009 Annual Report to Congress

Volume One

TAXPAYER ADVOCATE
IRS SERVICE
YOUR VOICE AT THE IRS

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Dedication

In Memoriam

This report is dedicated

to

Donald C. Alexander

Former IRS Commissioner,

a man of great courage,

a tireless protector of taxpayer rights,

and a great supporter of the

Taxpayer Advocate Service.

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Honorable Members of Congress:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Fundamental Tax Simplification Is Desperately Needed.

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

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

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

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

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

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

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

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

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

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

Conclusion

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

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

Respectfully Submitted,

Nina E. Olson
National Taxpayer Advocate
31 December 2009

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

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

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

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

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

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

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

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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 2009, the National Taxpayer Advocate has identified, analyzed, and offered recommendations to assist the IRS in resolving 21 such problems. This year's report also includes two status updates on the IRS's efforts to assist victims of tax-related identity theft and Federal Payment Levy Program levies on Social Security benefits, which the National Taxpayer Advocate identified and analyzed as Most Serious Problems in previous Annual Reports.[1]

As in earlier years, this report discusses 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 to a point where the IRS employs more than 100,000 people and collects in excess of $2 trillion each year from individuals, small and large businesses, and tax-exempt entities.[2] 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.

1 *See* National Taxpayer Advocate 2008 Annual Report to Congress 79-94; National Taxpayer Advocate 2007 Annual Report to Congress 96-115; National Taxpayer Advocate 2005 Annual Report to Congress 180-91; National Taxpayer Advocate 2004 Annual Report to Congress 133-36; National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, 46-72 (*Building a Better Filter: Protecting Lower Income Social Security Recipients from the Federal Payment Levy Program*); National Taxpayer Advocate 2007 Annual Report to Congress 324-36; National Taxpayer Advocate 2006 Annual Report to Congress 110-29, 141-56; National Taxpayer Advocate 2005 Annual Report to Congress 123-35; National Taxpayer Advocate 2004 Annual Report to Congress 246-63; National Taxpayer Advocate 2003 Annual Report to Congress 206-12; National Taxpayer Advocate 2001 Annual Report to Congress 202-09.

2 *See* Treasury Inspector General for Tax Administration, http://www.treas.gov/press/releases/docs/yes09_tables.pdf.

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 21 issues and the two status updates in this section of the Annual Report were ranked according to the following criteria:

- 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) and Systemic Advocacy Management System data.

After reviewing this ranking, the National Taxpayer Advocate identifies five issues which are, in her judgment after taking into consideration all of the above factors, the ones most in need of attention and thus requiring the most prominent placement in the ranking. Finally, the National Taxpayer Advocate and the Office of Systemic Advocacy examine the results of the ranking on the remaining issues and adjust it where editorial or numeric considerations warrant a particular placement or grouping. This year, six problems that deal with IRS examination issues are grouped together and share a common introduction,[3] while four other problems target collection issues.[4]

Taxpayer Advocate Management Information System List

The identification of the most serious problems reflects not only the mandates of Congress and the IRC, but the Taxpayer Advocate Service's (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 TAMIS. The top 25 case issues, which are listed in Appendix 1, reflect TAMIS receipts based on taxpayer contacts in fiscal year 2009, a period spanning October 1, 2008, through September 30, 2009.

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

4 See Most Serious Problems: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of the Law, Fail to Promote Future Tax Compliance, and Unnecessarily Harm Taxpayers; The Steady Decline of the IRS Offer in Compromise Program Is Leading to Lost Opportunities for Taxpayers and the IRS Alike; The IRS's Approach Toward Taxpayers During and After Bankruptcy May Impair Their "Fresh Start" and Future Tax Compliance;* and *IRS Policies and Procedures for Collection Statute Expiration Dates Adversely Affect Taxpayers, infra.*

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 (with the exception of correcting typographical or clerical errors), 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 TAS. To comply with IRC § 6103, which generally requires the IRS to keep taxpayers' returns and return information confidential, the details of the fact patterns have been changed. In some instances, the taxpayer has provided a written waiver to the National Taxpayer Advocate to use facts specific to that taxpayer's case. These exceptions are noted in footnotes to the examples.

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

RESPONSIBLE OFFICIALS

Richard E. Byrd Jr., Commissioner, Wage and Investment Division
Chris Wagner, Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

The federal tax system impacts just about every person in the United States. Tens of millions of taxpayers contact the IRS each year, seeking assistance with tax law questions, orders for publications and forms, or account-related issues.[1] A recent survey shows that when taxpayers have questions, their preferred method of contacting the IRS is by telephone.[2]

Over the last three years, however, taxpayers have found it increasingly difficult to reach an IRS telephone assistor. During the 2007 tax return filing season, the IRS attained a Customer Service Representative Level of Service (CSR LOS) of 83 percent on its toll-free lines.[3] In the 2008 filing season, the CSR LOS declined to 77 percent.[4] During the 2009 filing season, the service level dropped further to 64 percent with a 519-second average speed of answer (ASA), which means the average caller sat on hold for nearly nine minutes.[5] These declining numbers indicate that the IRS is not achieving its goal of improving service to facilitate voluntary compliance.[6]

In response to the declining levels of phone service, the IRS has set goals of 71.2 percent for CSR LOS and 698 seconds for ASA in fiscal year 2010.[7] In other words, the IRS has set its priorities so that nearly three out of every ten calls seeking to reach an IRS telephone assistor will not get through, and callers who do receive assistance will first have to wait on hold for an average of nearly 12 minutes.[8]

1 IRS, Joint Operations Center (JOC) Enterprise Telephone Data, *Product Line Detail Report.*

2 IRS Oversight Board, *2008 Taxpayer Attitudes Survey* (Feb. 2009).

3 IRS, JOC Enterprise Telephone Data, *Enterprise Snapshot.*

4 *Id.*

5 Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2009-40-127, *Unplanned Call Demand Reduced Toll-Free Telephone Access for the 2009 Filing Season* 5 (Sept. 8, 2009).

6 IRS, *Strategic Plan and Budget FY 2010*.

7 IRS, Wage and Investment Division (W&I), *Business Performance Review* 28 (Aug. 11, 2009).

8 The IRS operates multiple toll-free phone lines. Calls to the Customer Assistance Service (CAS) lines account for 80 to 90 percent of the toll-free calls to the IRS each year. In this discussion, we will focus on the CSR LOS for the CAS toll-free lines.

To live up to its customer service promises, the IRS should address the following problems with its toll-free phone service:

- The toll-free phone lines are insufficiently staffed to achieve an acceptable CSR LOS and ASA; and
- IRS projections for CSR LOS and ASA make no allowances for special tax initiatives and national disasters, which have become the norm rather than the exception.

ANALYSIS OF PROBLEM

Background

When Charles Rossotti began his term as the Commissioner of Internal Revenue in 1997, one of his greatest challenges was to improve customer service. During the 1997 filing season, 21.6 million callers attempted to reach the IRS via the toll-free lines, with a 52.3 percent success rate.[9] Deficiencies in phone service contributed to Congress's decision to overhaul the IRS organization in 1998, when the IRS achieved a 69 percent CSR LOS for the filing season.[10] In his book, *Many Unhappy Returns: One Man's Quest to Turn Around the Most Unpopular Organization in America,* Rossotti stated pointedly: "Apart from the justifiable outrage it causes among honest taxpayers, I have never understood why anyone would think it is good business to fail to answer a phone call from someone who owed you money."[11] Rossotti likened the phone service situation at the IRS to a bank that refused to spend money on providing service to customers, except those with long-overdue loans.[12]

The IRS measures the performance of its phone assistors by level of service and average speed of answer. Customer Service Representative Level of Service is the IRS's primary measure of taxpayer access to an assistor, while ASA measures the average number of seconds taxpayers wait on hold.[13] The IRS has increased the availability of telephone assistors on its toll-free lines in recent years, yet CSR LOS has declined while the corresponding waiting time has jumped dramatically. The table below contains IRS toll-free call data for the past six fiscal years.[14]

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9 General Accounting Office (GAO), GAO/T-GGD/AIMD-97-66, *Tax Administration: IRS' Fiscal Year 1997 Spending, 1997 Filing Season, and Fiscal Year 1998 Budget Request* 9 (Mar. 18, 1997).

10 GAO, GAO-01-189, *IRS Telephone Assistance: Quality of Service Mixed in 2000 Filing Season* 7 (Apr. 2001).

11 Charles O. Rossotti, *Many Unhappy Returns: One Man's Quest to Turn Around the Most Unpopular Organization in America* 285 (2005).

12 *Id*. at 129.

13 TIGTA, Ref. No. 2009-40-127, *Unplanned Call Demand Reduced Toll-Free Telephone Access for the 2009 Filing Season* 2 (Sept. 8, 2009). CSR LOS measures the relative success rate of taxpayers who call the toll-free lines seeking assistance from customer service representatives. Here is the CSR LOS formula: (Assistor Calls Answered + VCR Answered + Informational Messages) divided by (Assistor Calls Answered + VCR Answered + Informational Messages + VCR Busies + Courtesy Disconnects + Emergency Closed + Secondary Abandons + Calculated Busy Signals). *See* IRS Performance Measures Data Dictionary, *available at* http://cfo.fin.irs.gov/AssistReview/docs/FY%202009%20MD&A%20Data%20Dictionary%2008-04-09.doc (last visited Oct. 27, 2009). Note that CSR LOS is not a measurement of the total number of callers to the toll-free lines who speak with a customer service representative.

14 The IRS fiscal year (FY) is from October 1 to September 30. Elsewhere in this report, we refer to data for a particular filing season, which extends from January 1 to mid-April.

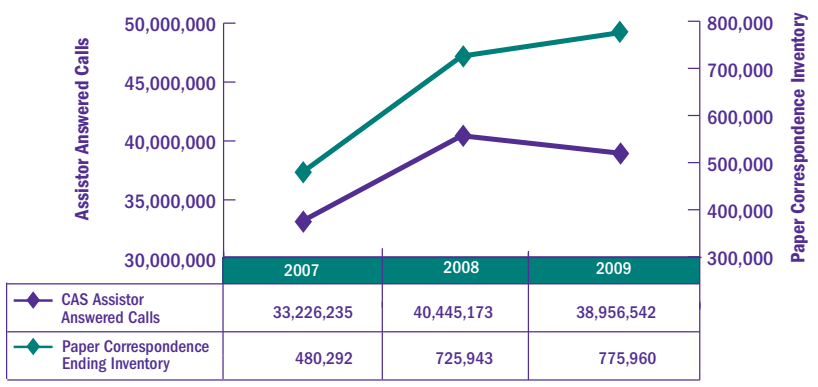
TABLE 1.1.1, IRS Customer Account Services Toll-Free Phone Data, FY 2005 – FY 2009[15]

Fiscal Year	CAS Net Attempts (in millions)	CAS Assistor Answered Calls (in millions)	Customer Service Representative Level of Service	Average Speed of Answer (in seconds)
2005	64.5	33.4	82.6%	258
2006	64.2	33.2	82.0%	242
2007	67.4	33.8	81.3%	268
2008	150.6	40.4	52.8%	626
2009	93.7	39.0	70.0%	526

Downstream Consequences of Low Toll-Free Level of Service

IRS Accounts Management (AM) employees who answer the toll-free phone lines also handle paper correspondence (including processing amended returns).[16] One way the IRS adjusts for fluctuating call volume is by moving AM staff from correspondence to phone (and *vice versa*).[17] The following chart compares Customer Account Services calls and calls answered by an assistor to overage correspondence.

CHART 1.1.2, Comparison of Customer Account Services Calls to Paper Correspondence[18]



As shown in Chart 1.1.2, ending inventories for paper correspondence rose as assistor-answered telephone calls to CAS toll-free lines increased, and even continued to rise after phone demand declined. The correspondence inventory has generally grown over time

15 IRS, JOC Enterprise Telephone Data, *Snapshot & Half Hourly Adherence Reports* (Oct. 30, 2009).

16 Internal Revenue Manual (IRM) 1.4.16.2 (Jan. 1, 2009).

17 IRM 1.4.16.2.2 (3) and (4) (Jan. 1, 2009).

18 IRS, JOC Enterprise Telephone Data, *Enterprise Snapshot & JOC Accounts Management Paper Inventory Adjustments Reports FY05, FY07, FY09* (Oct. 30, 2009). These calls were made to the telephone lines the IRS refers to as CAS toll-free, which includes 15 to 22 toll-free lines, depending on the fiscal year.

from 480,000 in FY 2007 to 776,000 in FY 2009.[19] Overage correspondence has varied over this same period from a weekly low of 54,000 to a weekly high of more than 1.1 million.[20]

When taxpayers cannot get through on the toll-free lines, they and the IRS face significant repercussions. For example, a taxpayer's inability to get answers could cause him or her to file a return containing errors, which in turn could lead to an IRS notice, audit, or collection actions.

Challenges to Maintaining or Improving Toll-Free LOS

While the IRS recognizes the importance of providing quality service to taxpayers through its toll-free phone lines, it faces several challenges in maintaining that service.

Significant Increase in Volume of Calls

The IRS receives tens of millions of telephone calls each filing season from taxpayers seeking assistance in understanding and meeting their tax obligations.[21] Even with a substantial presence on the Internet, the IRS has experienced a significant increase in toll-free calls in recent years.[22]

Difficulty in Ascertaining Appropriate Level of Staffing

Between FY 2007 and FY 2009, the call volume to the CAS toll-free lines increased by nearly 40 percent.[23] Even with a 13 percent increase in available assistor hours, the CAS assistors could answer only 15 percent more calls during this period while the IRS's automated systems answered 26 percent more.

There are a number of reasons why the IRS has been unable to keep up with the increased call volume, despite increasing its staffing. For example, the IRS noted that many of the simpler inquiries traditionally handled by the toll-free lines (such as "Where's My Refund?" and "How Much was My Stimulus Payment?" inquiries) have been diverted to automated applications. As a result, the toll-free assistors are left answering the more complex questions that remain, thereby increasing the amount of time spent on each call.[24] We suggest that the IRS continue to analyze its call data and base its toll-free assistor staffing decisions on this analysis.

19 IRS, *JOC Accounts Management Paper Inventory Adjustments Reports FY05, FY07, FY09* (Oct. 30, 2009).

20 *Id*. The amount of overage correspondence peaked in July 2008 when 1.1 million accounts' correspondence was overage.

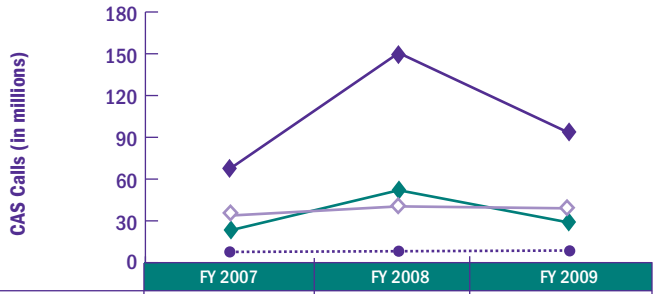
21 The filing season refers to the period from January through mid-April of each year when most individual tax returns are filed. IRS toll-free assistors received 75.7 million calls during the 2009 filing season. *See* TIGTA, Ref. No. 2009-40-127, *Unplanned Call Demand Reduced Toll-Free Telephone Access for the 2009 Filing Season* 1, 3 (Sept. 8, 2009).

22 *See* Table 1.1.1, IRS Customer Account Services Toll-Free Phone Data, FY 2005 – FY 2009, *supra*.

23 IRS, JOC Enterprise Telephone Data, *Snapshot & Half Hourly Adherence Reports* (Sept. 4, 2009). These calls were made to the lines the IRS refers to as CAS toll-free, which includes 15 to 22 toll-free lines, depending on the fiscal year.

24 *See* IRS response to information request (Nov. 2, 2009).

CHART 1.1.3, IRS Customer Account Services Toll-Free Call Volume, Answered Calls, and Available Assistor Hours, FY 2007 – FY 2009[25]



	FY 2007	FY 2008	FY 2009
Net Attempts	67.4	150.6	93.7
Assistor Answered Calls	33.8	40.4	39.0
Automated Calls Answered	23.1	52.0	29.0
Available Assistor Hours	7.7	8.2	8.7

Effect of Late-Year Tax Law Changes and Response to National Disasters

The National Taxpayer Advocate understands that the IRS has been presented with a number of challenges in recent years, such as administering the Economic Stimulus Payments, Recovery Rebate Credit, and America Recovery and Reinvestment Act. In addition, recent national disasters (including hurricanes Katrina and Rita) have impacted the taxpaying population and IRS operations.

The IRS points to these challenges as a cause of the decline in toll-free CSR LOS. It is true that when a special situation arises, phone service is often one of the things that suffer. For instance, when a national disaster strikes, the IRS moves some of its phone centers offline to answer Federal Emergency Management Agency questions.[26] These special situations have become the new "norm" for the IRS, although that norm is not reflected in its staffing models.

Because taxpayer phone assistance is so important to taxpayer compliance, the IRS should plan for such tax law changes and national disasters. Were the IRS to request funding for a "special phone unit" dedicated to handling these contingencies, the National Taxpayer Advocate believes that Congress would provide it.

25 IRS, JOC Enterprise Telephone Data, *Snapshot & Half Hourly Adherence Reports* (Sept. 4, 2009). These calls were made to the telephone lines the IRS refers to as CAS toll-free, which includes 15 to 22 toll-free lines, depending on the fiscal year. Automated calls include calls answered during open and after hours, calls that heard informational messages, and calls to Tele-Tax. Assistor answered calls include those who spoke to a live assistor. Net attempts include total calls (assistor plus automated) answered plus abandons, busies, emergency closed messages and courtesy disconnects.

26 IRM 25.16.1.7.5.3 (May 28, 2009); IRS News Release, *IRS Creates Disaster Relief Number for Toll-Free Line*, IR-2005-88 (Sept. 1, 2005) (on file with TAS).

Since the same employee base answers the phones, processes correspondence, and adjusts accounts, the IRS's traditional approach to unanticipated demand is to move employees from "paper" to "phones" as demand rises.[27] As noted above, this approach leads to overage inventories of correspondence, which in turn lead to additional phone calls or correspondence from taxpayers checking on the status of their issues. During the first five months of 2008 (when IRS toll-free assistors fielded calls about the Economic Stimulus Payment), call volume rose to a high of nearly 11 million in one week.[28] In January 2008, roughly 23 percent of paper correspondence was overage (paper correspondence inventory that was not worked in the allotted amount of time); however, by August 2008, overage correspondence exceeded 57 percent.[29]

The creation of a special phone unit would enable the IRS to maintain a high level of service for its routing calls while addressing unanticipated demand. If the IRS does not have to deal with a disaster or major tax change in a particular year, then the special unit can answer regular phone lines or handle correspondence. There is nothing wrong in achieving a higher CSR LOS or lower rate of overage correspondence than the goal!

Retreat from Singular Focus on Internet for Taxpayer Service

Through research, we know that taxpayers like to have options for communicating with the IRS.[30] Despite this finding, the IRS has increasingly relied on its website to get information to taxpayers. While the Internet is useful for tasks such as obtaining forms and publications, taxpayers may be less likely to use this medium to obtain answers to more complex questions, such as tax law or specific account issues. For instance, one survey showed 51 percent of taxpayers preferred to call the IRS with a tax law question, compared to only 21 percent who preferred the website.[31] In addition, some groups of taxpayers are less likely than others to have access to the Internet, or may have limited computer literacy.[32]

Directing the majority of resources to the Internet does not always yield the desired or expected results, as some in the private sector already realize. Banks initially thought they could reduce costs by eliminating many of their full-service branches and introducing online banking and bank-by-phone services. However, these banks soon found that while their customers used the new services for many needs, there was still a high demand for full-service facilities. In fact, the number of bank branches increased more than 30 percent

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27 IRM 1.4.16.2 (Jan. 1, 2009).

28 IRS, JOC Enterprise Telephone Data, *Enterprise Snapshot Reports, Weeks Ending Jan. 5 - May 31, 2008*.

29 In January 2008, correspondence overage was roughly 23 percent; in August 2008, overage was up to 57 percent. IRS, *JOC Accounts Management Paper Inventory Adjustments Reports FY 2005 – FY 2009* (Oct. 30, 2009).

30 In almost every situation, taxpayers prefer in-person assistance over self-help options like automated phone systems or Internet. Further, taxpayers overwhelmingly prefer in-person assistance over self-help option when it comes to account related issues. *See* IRS, *Taxpayer Assistance Blueprint Phase 2*, 40 (2007). Another survey showed that the toll-free line was by far the preferred option, by a margin of almost two to one. *See* IRS Oversight Board, *Channels Survey* 15 (Nov. 2006).

31 IRS Oversight Board, *Channels Survey* 15 (Nov. 2006).

32 *See* Most Serious Problem: *Beyond EITC: The Needs of Low Income Taxpayers Are Not Being Adequately Met, infra*; National Taxpayer Advocate 2006 Annual Report to Congress vol. 2, 2, 18 (Most Serious Problem: *Study of Taxpayer Needs, Preferences, and Willingness to Use IRS Services*).

from 1998 to 2008.[33] These banks essentially discovered that online services complement, but do not replace, traditional channels of communication and that a successful bank offers multiple methods of delivery for its products and services.[34]

The same may be true for the IRS. Taxpayers use the Internet for some but not all services. Some applications are certainly well-suited for the Internet and will reduce calls (*e.g.*, the "What's my AGI (Adjusted Gross Income)?" page can help taxpayers find information they need to file electronically). For more complicated questions or tasks, taxpayers may prefer the phone.

The IRS should follow the private sector's lead, as well as rely on its own survey data, and recognize that taxpayers want options. Successful customer service means providing a number of ways to reach the IRS. Relying too heavily on one mode of communication will cut off some of the taxpayer population and may discourage this group from contacting the IRS.

CONCLUSION

The IRS has made significant strides since the reorganization that began with the IRS Restructuring and Reform Act of 1998. The current environment of increasing phone demand and inadequate staffing reverses this trend. The declining CSR LOS and lowered goal for FY 2010 harm taxpayers and create re-work for the IRS.

In conclusion, the National Taxpayer Advocate offers these preliminary recommendations:

1. The IRS should staff the toll-free lines sufficiently to achieve a CSR LOS of 85 percent and an ASA of 300 seconds;
2. The IRS should develop and staff a special phone unit to deal with tax issues relating to national disasters and late-year tax law changes; and
3. The IRS should develop a research-driven strategy of providing Internet, face-to-face, and phone services based on actual taxpayer needs and preferences.

IRS COMMENTS

The IRS is dedicated to providing the best possible service to customers. Despite significant challenges during the last two years, more customers have received service at a higher quality level than ever before and overall customer satisfaction with our toll-free service remains very high.

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33 Federal Deposit Insurance Corporation (FDIC), *FDIC-Insured Commercial Banks, U.S. and Other Areas* (on file with TAS); FDIC, *Future of Banking Study: Bank Branch Growth Has Been Steady – Will It Continue?* (2004), *available at* http://www.fdic.gov/bank/analytical/future/fob_08.pdf (last visited Dec. 23, 2009).

34 Colliers International, *The Skyrocketing Number of Bank Branches, available at* http://www.ctmt.com/pdfs/emergingDirections/BankBranchesSkyrocket.pdf (last visited Oct. 19, 2009).

Since 2008, increased customer demand, introduction and expansion of new programs such as the Identity Protection Specialized Unit, and the increased complexity of the issues handled by telephone assistors has resulted in lower reported telephone service levels than in prior years (*i.e.*, CSR LOS and ASA). However, these two telephone service metrics alone do not adequately convey the full measure of services provided by the IRS, either through the phones or other channels. IRS accomplishments with regard to improved internet services are outlined in our comments for the Most Serious Problem on e-Services elsewhere in this report.[35] Likewise, the services provided by IRS-supported volunteers and IRS Taxpayer Assistance Centers are described in our response to the Most Serious Problem on low income taxpayers.[36] Specifically with regard to telephone service during the last two years, the IRS is pleased to report the following achievements:

- Live telephone assistance in fiscal years 2008 and 2009 was 40.4 million calls and 39 million calls respectively. This compares to 33.8 million assistor calls answered in 2007. Total calls answered, including automated services, in 2008 were 77.4 million and total calls answered in 2009 were 57.4 million. This compares to 46.2 million total calls answered in 2007.[37] In addition, use of the self-service Internet application *Where's My Refund?* increased from 39.2 million in 2007 to 54.4 million in 2009, thus enabling our skilled toll-free assistors to focus on resolving more complex customer calls.[38]
- The IRS added an estimated wait time feature for the majority of callers while they are on hold so they can make an informed decision about whether to remain on the line or call back at a later time.
- In 2008, the IRS achieved an accuracy rate of 91.2 percent for tax law inquiries and 93.7 percent for account inquiries. In 2009, our accuracy rate increased to 92.9 percent for tax law and 94.9 percent for accounts, exceeding our goals by 1.9 percent and 1.4 percent respectively.[39] These accuracy rates reflect the results of dedicated and successful multi-year efforts by the IRS to improve the quality of its telephone services to world-class levels.
- In fiscal years 2008 and 2009, the IRS maintained a toll-free customer satisfaction rate of 93.0 percent.[40] Notwithstanding the issues raised by the National Taxpayer Advocate, such high customer satisfaction reflects very favorably on both the level and quality of IRS telephone services.

In an effort to enhance our customer service, the IRS has several improvement initiatives in progress. We recently made changes to our toll-free menus to clarify options and get the

35 See Most Serious Problem: *The IRS Lacks a Servicewide E-Services Strategy, infra*.

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

37 JOC fiscal year-end snapshot reports.

38 JOC Internet Refund-Fact of Filing (IRFOF) file.

39 National Quality Review (NQRS).

40 IRS Customer Satisfaction Surveys.

customer to the right place more quickly. We also continue to expand customer channel options. As noted above, the Internet has provided a vehicle for successfully offering self-service opportunities to a customer segment that prefers that method of contact. However, this added access to information or assistance through the Internet is never to the exclusion of other channels.

Level of Service

The IRS agrees it should staff the toll-free lines sufficiently to provide a reasonable and cost-effective level of service. To this end, our goal for CSR LOS in 2010 is 71.0 percent and represents anticipated demand and the resources appropriated for the IRS to meet that demand. Resources available to deliver telephone services are finite and staffing allocations must be made in light of competing demands necessary to meet other customer needs and preferences. The IRS believes a balanced delivery of services through telephone, Internet, face-to-face, and correspondence ensures that our customers, regardless of the channel they choose, receive the best service possible.

Special Phone Unit

The IRS also believes it would be impractical and inefficient to establish a special phone unit dedicated to contingencies. However, the IRS has employed a comparable but more cost-effective approach for many years by hiring seasonal staff whose work periods can be expanded or contracted based on fluctuating workload demands. In addition, the IRS utilized several other options to handle the unexpected and extraordinary customer demand for telephone assistance that occurred during the 2008 and 2009 filing seasons. This unanticipated demand primarily resulted from the economic stimulus and recovery act legislation, as well as a new e-file authentication requirement that made it necessary for taxpayers to know their prior year adjusted gross income. IRS efforts to meet this demand included the addition of new Internet self-service tools such as *How Much Was My Stimulus Payment?*, diversion of staff from other programs during peak demand periods to handle prior year AGI calls, special processing of Recovery Rebate Credit (RRC) math error calls, and redesign of the Economic Stimulus Payment Hotline to include automated information on both the new ARRA legislation and the RRC. In addition, both to address the increased demand during 2008 and 2009, and for the longer term, the IRS moved certain paper adjustments work previously handled by Accounts Management to Field Assistance and Submission Processing, thus allowing more Accounts Management assistors to be dedicated to the phones.

Research-Driven Strategy

With regard to the National Taxpayer Advocate's comments regarding development of a research-driven strategy of providing Internet, face-to-face, and phone services based on actual taxpayer needs and preference, the IRS agrees and already has just such a strategy. On April 11, 2007, the IRS delivered to Congress the Taxpayer Assistance Blueprint (TAB) Phase 2 report, a five-year strategic plan for improving taxpayer services.

Recently updated for Congress, the TAB was co-authored by the IRS, the National Taxpayer Advocate, and the IRS Oversight Board. In the TAB, the IRS commits to "offering a portfolio of service options delivered across multiple channels." While appropriate emphasis is placed on enhancing self-assisted services, particularly those found on the IRS website, the need to ensure "alternative channels are available" remains a core principle. The telephone performance issues raised in the National Taxpayer Advocate's report, taxpayer access and burden, are specifically recognized and addressed in the TAB. In addition, the philosophy, priorities, and guiding principles of the TAB are clearly reflected in the 2009-2013 IRS Strategic Plan. Because operating division planning documents and IRS budget proposals are directly linked to the Strategic Plan, they too reflect the goal of providing and administering improved taxpayer services from the taxpayer's perspective.

The TAB is grounded in substantial and varied research on the service needs and channel preferences of taxpayers. An important advancement in our understanding of these needs and preferences is research that explored the relationship between taxpayer characterization of a specific service task, demographic attributes, and expectations for service channel performance. This "tradeoff" or "conjoint" research revealed new insights regarding taxpayer perceptions of service channels value and the potential burden for satisfying specific service tasks. Subsequent IRS research has taken the conjoint data findings and examined taxpayer decision-making processes. These include the role perceived service task complexity plays in service channel choices, the link between service channel performance (anticipated and realized) and taxpayer behavior, and on-going analysis of the relationship between taxpayer demographics, service task/needs channel preferences, and actual channel use.

True to the TAB guiding principle emphasizing service options and choice, current and planned taxpayer-focused IRS research is supporting decisions regarding service resource and workload allocations, service application development, and performance goals and measures across the IRS phone, Internet, face-to-face, and correspondence delivery channels.

Summary

In conclusion, the IRS remains dedicated to providing the best possible telephone services for our customers while balancing service delivery among all channels. The IRS will also continue its TAB-related research in support of our strategy for providing cost effective, taxpayer-focused services through multiple channels that meet the needs and preferences of individual, business and tax exempt customers.

Taxpayer Advocate Service Comments

In essence, a successful approach to customer service depends on two things: (1) access to the service provided to customers, and (2) the quality of that service. This is the approach Congress has instructed the IRS to take with its toll-free lines.[41] However, rather than setting a goal that will satisfy Congress, the IRS has set a "goal" that will fail to answer nearly three out of every ten phone calls from taxpayers seeking assistance from a customer service representative.[42] This is unacceptable and fails the first tenet of good customer service – access. The IRS can strive to provide taxpayers with the best possible customer service, but if taxpayers do not have access to that service, the IRS will have failed to help taxpayers voluntarily comply with their tax obligations. The IRS can and should do better.

The National Taxpayer Advocate understands that the IRS is working to improve its customer service by clarifying its menu options on the toll-free lines and enhancing Internet services. She commends the IRS for these efforts and she applauds the high accuracy levels and the customer satisfaction of those who get through to a customer service representative – these are indeed significant achievements. However, the National Taxpayer Advocate believes that good customer service begins with toll-free lines where taxpayers can reach a live assistor to receive answers to their questions. In recent years, an increasing number of taxpayers have been unable to reach the IRS via the toll-free lines.

Merely looking at the number of calls answered by an assistor does not tell the full story of the decline of IRS's CAS toll-free phone service. To truly evaluate the performance of these toll-free lines, it is necessary to also look at the CSR LOS. As shown in Table 1.1.1, CSR LOS for the CAS toll-free lines have significantly decreased over the past several years, dipping to 53 percent in FY 2008 and 70 percent in FY 2009.[43] This is a significant drop from FY 2005 to FY 2007, where the CSR LOS remained in the 80 percent range.[44]

The National Taxpayer Advocate is pleased that the IRS has enhanced its phone lines so taxpayers will now be aware of how long they must wait to talk to an IRS employee, giving them the opportunity to decide if they want to wait or call back at another time. However, the primary objective should be to keep the waiting time from becoming too long. As illustrated in Table 1.1.1, the CAS toll-free lines had an Average Speed of Answer of 526 seconds in FY 2009, almost double the ASA of 268 in FY 2007.[45]

41 "The Commissioner shall continue to make the improvement of the Internal Revenue Service 1-800 help line service a priority and allocate resources necessary to increase phone lines and staff to improve the Internal Revenue Service 1-800 help line service." H.R. Rep. No. 111-366, FY 2010 Consolidated Appropriations Act, Division C (2009) (Conf. Rep.).

42 IRS, W&I, *Business Performance Review* 28 (Aug. 11, 2009).

43 IRS, JOC Enterprise Telephone Data, *Snapshot & Half Hourly Adherence Reports* (Oct. 30, 2009).

44 *Id.*

45 *Id.*

The IRS's excellent 93 percent customer satisfaction rate for FY 2008 and 2009 tells only part of the story. Presumably, this customer satisfaction survey covered only those taxpayers who got through on the CAS toll-freelines, not the three out of every ten who could not reach an assistor or hung up because the wait was too long. While the National Taxpayer Advocate commends the IRS for having such a high satisfaction rate, she wishes that more taxpayers would be given the opportunity to speak to an IRS assistor in the first place.

The National Taxpayer Advocate believes that placing only seasonal employees on the phone lines, to address questions relating to national disasters or late-year tax law changes, is not comparable to having a special phone unit dedicated to these issues. Although it may be possible to utilize appropriately trained seasonal employees to address these questions, they should act as support to a specialized unit. The whole point of creating a special unit is for the IRS to train its staff to deal with these unique and often complicated, issues. Additionally, the IRS could call on this unit at any time and would not have to depend on the availability of seasonal employees. The IRS's current approach leaves it scrambling to solve one problem by diverting resources from another area. Establishing a specialized phone unit would avoid the need for temporary solutions that have downstream consequences, such as paper correspondence remaining in inventory as illustrated in Chart 1.1.2.[46]

The National Taxpayer Advocate is aware that the IRS, along with other stakeholders including the National Taxpayer Advocate, has conducted research on taxpayers' needs and preferences and commendes the IRS for doing so. However, the decline in toll-free LOS illustrates that the IRS is unable to apply this research to achieve the desired result of providing taxpayers with access to the IRS through different channels. Instead, a taxpayer's chances of reaching the IRS by telephone have significantly decreased in recent years.

Only maintaining current resources to the toll-free lines will have significant consequences for taxpayers today and in the future and will result in a decline in tax compliance. Providing taxpayers with access to quality customer service is one of the IRS's most important responsibilities and one of the cornerstones of RRA 98. Not taking action now risks a return to pre-1998 level of service. The National Taxpayer Advocate believes that Congress, the Administration, and the IRS must jointly ensure that such a state does not occur.

46 IRS, JOC Enterprise Telephone Data, *Enterprise Snapshot & JOC Accounts Management Paper Inventory Adjustments Reports FY05, FY07, FY09* (Oct. 30, 2009).

Recommendations

The National Taxpayer Advocate recommends:

1. The IRS should staff the toll-free lines sufficiently to achieve a CSR LOS of 85 percent and an ASA of 300 seconds; and
2. The IRS should develop and staff a special phone unit to deal with tax issues relating to national disasters and late-year tax law changes.

MSP #2

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

RESPONSIBLE OFFICIALS

Richard E. Byrd Jr., Commissioner, Wage and Investment Division
Chris Wagner, Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

Properly applied, the notice of federal tax lien (NFTL) can be an effective tool in tax collection. It gives the IRS a priority interest in the taxpayer's property, such as a home or a car, and may enable the IRS to collect all or a portion of the tax debt if the taxpayer sells or refinances the property.

If improperly applied, however, tax liens have the potential to cause needless harm to taxpayers and undermine long-term tax collection. Assume, for example, that a taxpayer loses his job during a recession and becomes unable to pay his tax bill. The filing of a tax lien can significantly harm the taxpayer's credit and thus negatively affect his or her ability to obtain financing, find or retain a job, secure affordable housing or insurance, and ultimately pay the outstanding tax debt. Moreover, the government must consider that its role as a creditor is different from that of a private entity creditor. If the filing of a tax lien drives up the taxpayer's costs and renders him or her unemployed or underemployed, the government may be forced to make outlays in the form of unemployment benefits, food stamps, and the like. Thus, the imprudent filing of a tax lien has the potential to badly damage the taxpayer and the taxpayer's family and simultaneously *reduce* federal revenue – a lose-lose proposition.

For this reason, the decision whether to impose a tax lien should be made on a case-by-case basis. Yet, the IRS files many liens systemically, pursuant to "business rules" that require automatic lien filing or a lack of substantive human review.[1]

The National Taxpayer Advocate has been hearing increasing complaints about lien processing in recent years, and this year we conducted a high-level research project on collection activities that, in part, attempted to assess whether liens are being filed effectively to collect revenue. To complete this assessment, TAS reviewed nearly 1.9 million transactions involving about 270,000 individual taxpayers who first incurred new balance-due liabilities during tax year 2002 (and who had no previous unpaid balances due at that time) and

[1] Automated Collection System (ACS), *Customer Service Activity Reports (CSAR), FY 2009 BOD report. See also* E-mail from IRS subject matter expert (Nov. 2, 2009); Internal Revenue Manual (IRM) 5.19.5.3.7 (Dec. 1, 2007); IRM 5.19.5.5.7 (May 29, 2008).

against whom NFTLs were filed in subsequent years.[2] The results of our research suggest that the IRS's use of liens may not be furthering the agency's revenue collection objective and, equally significant, that the IRS has shown very little interest in evaluating the effectiveness of liens for itself. Among our findings:

- There is no discernable causal relationship between the number of lien notices filed and the amount of revenue collected. Over the past decade, the IRS has increased its lien filings by nearly 475 percent – from about 168,000 in fiscal year (FY) 1999 to nearly 966,000 in FY 2009.[3] Yet overall inflation-adjusted (in terms of 2009 dollars) Collection revenue has declined by approximately 7.4 percent during this period.[4]
- IRS procedures require employees to code the source of all payments received on delinquent accounts.[5] Where the IRS received a payment after an NFTL was filed against a taxpayer's property, the IRS coded the source of payments as "miscellaneous" or did not code the payment at all in about 52 percent of the cases.[6] The IRS's failure to accurately code and track the source of payments largely defeats the purpose of having a coding system because it precludes the IRS (including TAS) from drawing useful conclusions about the effectiveness of its lien filings.
- In cases where the IRS did code the source of a payment as something other than "miscellaneous," our analysis found that more than 95 percent of all payments and more than 80 percent of all revenue collected did not result from the lien filings and would have been collected anyway.[7] The largest source of Collection revenue and payments on these accounts was refund offsets (*i.e.*, the taxpayer filed a return in a subsequent tax year showing a refund due and the IRS withheld the refund to satisfy the past-due tax debt), which occur regardless of the existence of an NFTL. Of the $905 million attributable to payments for which there is a designated payment code, only about $169 million was unambiguously attributable to lien filings with respect to 2002 delinquent tax liabilities.[8]

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2 TAS reviewed 1,886,683 transactions from 270,399 individual taxpayers. For a more detailed discussion, see *The IRS's Use of Notices of Federal Tax Lien (NFTL)*, vol. 2, *infra*.

3 IRS, *Statistics of Income (SOI) Data Books, Table 16, Delinquent Collection Activities, 1999-2008*; IRS, Collection Activity Report NO-5000-C23, *Collection Workload Indicators Reports* (Oct. 13, 2009). In FY 2009, the IRS filed 965,618 NFTLs.

4 *Id.* Small Business/Self-Employed division (SB/SE) response to TAS research request (Nov. 13, 2009). The SOI data is not available for FY 2009. For a more detailed discussion of IRS Collection data, see *Preface: Introductory Comments of the National Taxpayer Advocate, supra.*

5 *See* IRM 5.1.2.8.1 (Aug. 15, 2008). These two-digit numeric codes are called Designated Payment Codes (DPCs). The IRS uses DPCs to help identify payments, indicate application of payment to a specific liability, and identify the event that resulted in a payment.

6 IRS, Compliance Data Warehouse (CDW), Individual Masterfile (IMF) Transaction File Cycle 200913. Of the 1,886,683 total payment transactions, only 629,158 transactions had the DPC code assigned. 1,257,525 transactions were designated "miscellaneous" or "DPC indicator not present." Of the 1,257,525 transactions, 283,091 had a refund offset transaction code; leaving 974,434 payments (or 51.6 percent) as unaccountable. Thus, 912,249 payments (or 48.4 percent) had meaningful DPCs or could be identified as refund offsets. *See also* Chart 1.2.2, *Dollars Collected Attributable to Liens Filed Against TY 2002 Individual Taxpayer Liability and Subsequent Payments from CY 2002 to CY 2009, infra*. The IRS does not conduct a quality review of the payment information by DPC. IRS response to TAS research request (Oct. 6, 2009).

7 *See The IRS's Use of Notices of Federal Tax Lien (NTFL)*, vol. 2, *infra.*

8 IRS, CDW, IMF Transaction File Cycle 200913. The IRS collected $168.6 million in payments attributable to NFTLs and $736.7 million in payments not attributable to NFTLs from calendar year (CY) 2002 to CY 2009. *See* Chart 1.2.2, *Dollars Collected Attributable to Liens Filed Against TY 2002 Individual Taxpayer Liability and Subsequent Payments from CY 2002 to CY 2009, infra.*

The National Taxpayer Advocate has identified the following concerns with the IRS's NFTL policy:

- Lack of managerial review prior to most NFTL filings, which circumvents the provisions of § 3421 of the IRS Restructuring and Reform Act of 1998 (RRA 98);
- Lack of verification of assets prior to filing an NFTL;
- Unnecessary harm to taxpayers whose accounts are reported currently not collectible (CNC); and
- Failure by the IRS to fully utilize its statutory authority to withdraw NFTLs.

Such an approach to NFTL filing harms taxpayers and impairs both the collection of current tax debts as well as future compliance.

ANALYSIS OF PROBLEM

Background

The purpose of the NFTL is to protect the IRS's priority over other creditors.

A federal tax lien (FTL) arises when the IRS assesses a tax liability, sends the taxpayer notice and demand for payment, and the taxpayer does not fully pay the debt within ten days.[9] An FTL is effective as of the date of assessment and attaches to all of the taxpayer's property and rights to property, whether real or personal, including those acquired by the taxpayer after that date.[10] This lien continues against the taxpayer's property until the liability either has been fully paid or is legally unenforceable.[11] This statutory lien is sometimes called the "secret" lien, because third parties – and usually the taxpayer – have no knowledge of the existence of this lien or the underlying tax debt, and the taxpayer may not understand the significance of this statutory lien.[12] To put third parties on notice and establish the priority of the government's interest in a taxpayer's property against subsequent purchasers, secured creditors, and junior lien holders, the IRS must file an NFTL in the appropriate location, such as a county registrar of deeds.[13] It is IRS policy not to use the NFTL as a negotiating tool.[14] The IRS is required to release a lien not later than 30 days after the underlying liability either is fully satisfied through full payment of tax or is legally unenforceable (typically, by expiration of the statutory period for collecting the tax).[15] Once the certificate of release is issued and filed in the same office as the related NFTL, the tax

9 Internal Revenue Code (IRC) §§ 6321 and 6322. IRC § 6201 authorizes the IRS to assess all taxes owed. IRC § 6303 provides that within 60 days of the assessment the IRS must provide notice and demand for payment to any taxpayer liable for an unpaid tax.

10 *See* IRC § 6321; IRM 5.12.2.2 (May 20, 2005).

11 IRC § 6322.

12 IRC § 6321. The IRM refers to this statutory lien as a "silent" lien. *See* IRM 5.12.2.2 (May 20, 2005).

13 IRC § 6323(f); Treas. Reg. § 301.6323(f)-1; IRM 5.12.2.8 (Oct. 30, 2009).

14 IRM 5.12.2.1 (May 20, 2005).

15 IRC § 6325(a)(1).

lien is conclusively extinguished.[16] Under certain circumstances, the IRS may withdraw an NFTL, in which case the provisions of "this chapter [chapter 64 of subtitle F, relating to collection] shall be applied as if the withdrawn notice had not been filed."[17]

The NFTL impairs taxpayers' credit reports and unless appropriately applied, may impede taxpayers' financial viability and ability to pay past, current, and future taxes.

On average, a lien filing reduces a taxpayer's credit score by 100 points.[18] Unpaid tax liens may remain on a taxpayer's credit history, leaving a derogatory mark on the credit history indefinitely.[19] Released liens, including those paid off by the taxpayer, are not generally removed from the credit history until seven years from the date of release.[20] Thus, an NFTL has a significant long-term impact on a taxpayer's credit record.

As a result, some lenders decline to extend credit to a taxpayer if the IRS has filed an NFTL against the taxpayer's property. Others will charge substantially higher rates, even if the lien is subordinated.[21] Impaired credit history can also affect a taxpayer's ability to obtain insurance or rent an apartment on reasonable terms. Moreover, some licensing boards require members to maintain a clean credit history and some employers require employees to do so as a condition of employment.[22] Thus, a lien filing can mean that employees lose their jobs and self-employed individuals cannot maintain the licensing necessary to remain in business. It can also hamper the taxpayer's ability to stay compliant and obtain credit needed to pay preexisting tax debts.[23]

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16 IRC § 6325(f).

17 IRC 6323(j)(1). An NFTL may be withdrawn if the lien was filed prematurely or not in accordance with IRS procedures, the taxpayer entered into an installment agreement that did not by its terms require the filing of a lien, the withdrawal will facilitate collection, or the withdrawal is in the best interests of both the government and the taxpayer.

18 Written response from Vantage Score® (Sept. 17, 2009). The impact of the NFTL filing is greatest upon the initial filing and diminishes over time.

19 As a matter of policy, Experian keeps unpaid tax liens on a credit report for 15 years and Equifax for ten years, while Transunion credit reports reflect them indefinitely. Self-releasing liens are generally reported for ten years after the filing date unless the lien is refiled by the IRS. California requires that all liens, released and open, be removed from credit histories ten years after the filing date. *See* Cal. Civ. Code, § 1785.13(d).

20 The Fair Credit Reporting Act (FCRA), § 605(a)(3), 15 USC §1681c(a)(3). *See also* Federal Trade Commission, Statement of General Policy or Interpretation; Commentary on the Fair Credit Reporting Act, 55 Fed. Reg. 18804, 18818 (May 4, 1990). The filing of a release will be notated on the credit report but does not necessarily impact the credit score in a significant way.

21 *See, e.g.*, GMAC Factoring Agreement, *available at* http://contracts.onecle.com/arbinet/gmac.factor.2003.02.01.shtml (last visited Oct. 9, 2009). *See also* CTG Financial, Inc. Factoring Agreement, *available at* www.ctgfinancial.com/pdf/Factoring_Contract%20_3_20_09.pdf (last visited Oct. 9, 2009).

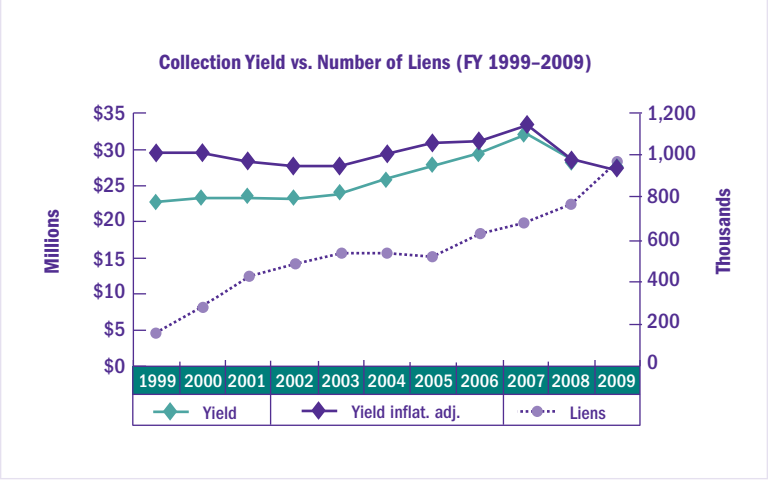
22 *See, e.g.*, Form U4, *Uniform Application for Broker-Dealer Registration*, Q14M (May 2009), *available at* http://www.finra.org/web/groups/industry/@ip/@comp/@regis/documents/appsupportdocs/p015112.pdf (last visited Oct. 6, 2009).

23 *See, e.g.*, IRC § 6323(d) (providing that security protection only extended to the lender for disbursements made within 45 days after the filing of the NFTL, or until the lender is provided actual notice of the NFTL); IRC § 3505(b) (holding a lender providing funds for the ongoing operation of a business potentially liable for unpaid withholding taxes if certain criteria are met).

The IRS has no means of tracking the effectiveness of NFTL filings in terms of collected tax revenue.

As noted above, IRS NFTL filings increased by about 475 percent from FY 1999 to FY 2009,[24] yet the IRS total collection yield has slightly increased on a slow, relatively consistent and gradual path in FYs 1999-2009.[25] In fact, when adjusted for inflation (in terms of 2009 dollars), the total collection yield declined by approximately 7.4 percent from $29.4 billion in FY 1999 to $27.2 billion in FY 2009.[26] Chart 1.2.1 below illustrates this trend from FY 1999 through FY 2009.

CHART 1.2.1, Absolute Dollar and Inflation-Adjusted Collection Yield and NFTLs Filed, FY 1999 – FY 2009



A recent TAS analysis of IRS payment data reveals that the IRS does not accurately track the source of tax payments received on past due accounts. In most instances where the payment source is specified, however, the IRS would have received the payment regardless of whether the lien was filed. The IRS assigns a specific numeric code (*i.e.*, a designated payment code or DPC), to each payment it receives to identify the source (*e.g.*, pursuant to an installment agreement (IA), offer in compromise (OIC), levy, seizure, or sale of asset).[27]

24 IRS, *Statistics of Income (SOI) Data Books, Table 16, Delinquent Collection Activities, 1999-2008*. IRS, Collection Activity Reports, *NO-5000-C23, Collection Workload Indicators Report* (Oct. 13, 2009). *See also* SB/SE response to TAS research request (Nov. 13, 2009).

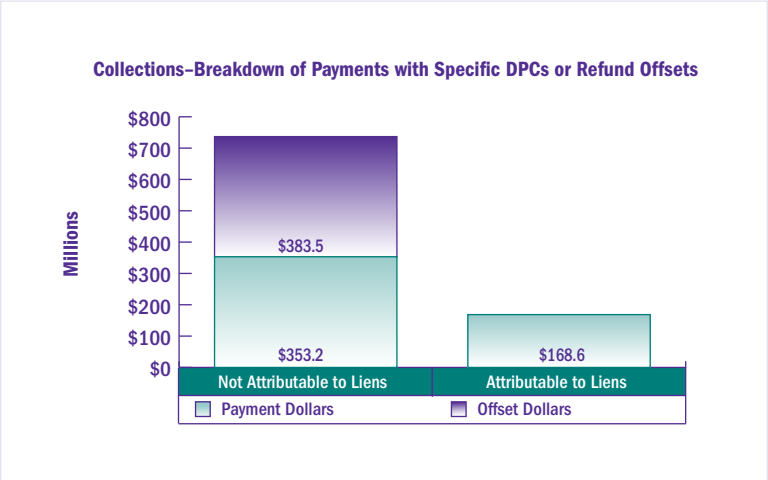
25 IRS, *SOI Data Books, Table 16, Delinquent Collection Activities, 1999-2008*. SB/SE response to TAS research request (Nov. 13, 2009). Total collection yield as reported in the SOI Data Book is any revenue collected attributable to IRS collection activities, such as levies, liens, and seizures. Total collection yield includes previously unpaid taxes on returns filed plus assessed and accrued penalties and interest. For FY 2008, it includes a total of $37,254,116 collected by private debt collection agencies. For a more detailed discussion, see *Preface: Introductory Comments of the National Taxpayer Advocate, supra.*

26 Bureau of Labor Statistics, Dept. of Labor, *Consumer Price Index – All Urban Consumers (CPI-U), at* http://www.bls.gov/CPI/ (last visited Oct. 10, 2009).

27 *See* IRM 5.1.2.8.1 (Aug. 15, 2008). These two-digit numeric codes are called Designated Payment Codes (DPCs). The IRS uses DPCs to help identify payments, indicate application of payment to a specific liability, and identify the event that resulted in a payment.

As noted above, TAS reviewed nearly 1.9 million transactions involving about 270,000 individual taxpayers who first incurred new balance-due liabilities during tax year 2002 (and who had no previous unpaid balances due at that time), and against whom NFTLs were filed in subsequent years.[28] In approximately 52 percent of all payment transactions attributable to these taxpayers, the IRS coded the payments as "Miscellaneous" or did not code them at all.[29] That is, the IRS does not know what prompted the taxpayer to make a payment in *over half* of the instances. Thus, neither TAS nor the IRS can determine in these cases whether any particular collection action (or none at all) was effective in generating tax payments for the liabilities incurred in TY 2002. Where the payments tracked were designated with a specific payment code, however, the revenue collected and attributable to NFTL filings amounted to less than *one-fifth* of the total revenue collected from these taxpayers, as shown in Chart 1.2.2 below. Chart 1.2.2 shows that of the nearly $905 million in payments for calendar year 2002 to CY 2009 for which there is a specific DPC, the IRS collected about $169 million attributable to the NFTL, and nearly $737 million not attributable to the NFTL.[30]

CHART 1.2.2, Dollars Collected Attributable to Liens Filed Against TY 2002 Individual Taxpayer Liability and Subsequent Payments from CY 2002 to CY 2009[31]



28 TAS reviewed 1,886,683 transactions from 270,399 individual taxpayers. For a more detailed discussion and description of this lien analysis and methodology, including payment allocation, see *The IRS's Use of Notices of Federal Tax Lien*, vol. 2, *infra*. It should be noted that we reconstructed the 48.4 percent total so that it included offsets. In 51.6 percent of the transactions, neither TAS nor the IRS can identify the source of payment.

29 IRS, CDW, IMF Transaction File Cycle 200913. Of the 1,886,683 total payment transactions, only 629,158 transactions had the DPC code assigned. 1,257,525 transactions were designated "miscellaneous" or "DPC indicator not present." Of the 1,257,525 transactions, 283,091 had a refund offset transaction code; leaving 974,434 payments (or 51.6 percent) as unaccountable. Thus, 912,249 payments (or 48.4 percent) had meaningful DPCs or could be identified as refund offsets. *See also* Chart 1.2.2, *Dollars Collected Attributable to Liens Filed Against TY 2002 Individual Taxpayer Liability and Subsequent Payments from CY 2002 to CY 2009, supra*. The IRS does not conduct a quality review of the payment information by DPC. IRS response to TAS research request (Oct. 6, 2009).

30 IRS, CDW, IMF Transaction File Cycle 200913.

31 *Id.* The IRS collected $168.6 million in payments attributable to NFTLs and $736.7 million in payments not attributable to NFTLs from CY 2002 to CY 2009.

Moreover, the number of payment transactions (regardless of amount) attributable to NFTLs represented less than five percent of all payments. Table 1.2.3 below breaks down the payments according to type.

TABLE 1.2.3, Total Payment Transactions from CY 2002 to CY 2009 by Type of Payment (Attributable to Liens Filed Against TY 2002 Individual Taxpayer Liability)[32]

Designated Payment Code Type	Not Lien Attributable		Offset		Lien Attributable		Total Number	Total Dollars (in thousands)
	Number	Dolllars (in thousands)	Number	Dolllars (in thousands)	Number	Dolllars (in thousands)		
Levies	562,656	$ (306,763)	15	$ 17	–	$ –	562,671	$ (306,746)
Refund Offsets	–	$ –	283,091	$ (384)	–	$ –	283,091	$ (383,665)
Bankruptcy and Suits	4,912	$ (3,072)	6	$ 16	22,058	$ (21,391)	26,976	$ (24,447)
Offers in Compromise	21,157	$ (27,201)	19	$ 49	–	$ –	21,176	$ (27,152)
Liens	20	$ (10,158)	2	$ 0.51	11,016	$ (147,070)	11,038	$ (147,080)
Installment Agreements	5,675	$ (5,679)	15	$ 22	–	$ –	5,690	$ (5,657)
Other DPCs	1,566	$ (10,497)	21	$ 39	–	$ –	1,587	$ (10,457)
Unrecognized DPCs	1	$ 0.04	13	$ 20	6	$ (106)	20	$ (86)
Total	**595,987**	**$ (363,370)**	**283,182**	**$ (220)**	**33,080**	**$ (168,568)**	**912,249**	**$ (905,291)**

The TAS analysis demonstrates that when the IRS files an NFTL and records specific payment codes, it collects far more revenue from offsets and payments not attributable to liens (such as levies, OICs, and IAs) than from the NFTLs. If the IRS seeks to understand the effectiveness of its lien and collection policies – and we believe it is critical that the IRS do so – it must first institute a quality review of payment coding.

Systemic lien filing circumvents key taxpayer protections enacted by RRA 98.

One reason the systemic lien filing does not generate a corresponding increase in collection revenue may be that the IRS files NFTLs against taxpayers who have little or no ability to pay or who have no assets from which to collect. In FY 2009, the IRS filed about 51 percent of all liens via its Automated Collection System.[33] Of the NFTL requests that ACS tracks, 61.7 percent were systemic (*i.e.*, IRS systems both made lien filing determinations

32 IRS, CDW, IMF Transaction File Cycle 200913. The total number of payments is 912,249, of which only 33,080 transactions were attributable to NFTLs. "DPC not present on Posting Voucher, Miscellaneous, or Missing" means valid DPCs with insignificant dollar amounts that cannot be classified in other categories and nonrecognized or invalid DPCs.

33 IRS, Collection Activity Report NO-5000-C23, *Collection Workload Indicators Reports* (Oct. 13, 2009). Of the 965,618 NFTLs filed in FY 2009, 491,822 were filed by the ACS.

and filed the liens, without the IRS first inquiring whether the taxpayer has any assets, or is likely to acquire assets, to which a lien could attach).[34]

Before the enactment of RRA 98[35] IRS employees had no statutory requirement to obtain managerial approval prior to an NFTL filing.[36] Recognizing that federal tax liens may impose a serious hardship on taxpayers, Congress enacted § 3421 of RRA 98 to provide an extra layer of protection for taxpayers in the form of an administrative approval process.[37] Under this process, a determination by an employee to file a lien would, where appropriate, be approved by an IRS supervisor who, in addition to other analysis, may include a certification that the employee has reviewed the taxpayer's information, verified the balance due, and affirmed that the action proposed is appropriate, considering the amount due and the value of the property.[38] This provision also requires that the failure to follow such procedures should result in appropriate disciplinary action against the supervisor or IRS employee responsible for the failure.[39] In the case of liens or levies issued by ACS, the IRS was given discretion to determine where supervisory review is or is not appropriate.[40]

When the IRS considered implementation of the RRA 98 lien approval requirement, it decided to continue limiting managerial review to only those liens filed by lower-graded revenue officers (ROs), specifically those below the GS-9 level.[41] However, in FY 2009, only about 14 percent of ROs (541 of 3,752) were below that level.[42] In ACS, lower-graded employees (*i.e.*, GS-7 and below) historically required approval from a senior RO or a manager to file a lien,[43] but today, ACS employees at the GS-6 level are authorized to file an NFTL without managerial approval.[44]

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34 ACS *Customer Service Activity Reports (CSAR), FY 2009 BOD report. See also* IRS response to TAS research request (Oct. 30, 2009). ACS systemic programming retrieves cases with expired follow-ups in R7 status (accounts with a 25-day follow-up where the system generated an LT39, *Reminder Notice*), determines whether the aggregate assessed balance is greater than $5,000, and determines whether there are any modules without a lien. If all three of these criteria are met, the system generates a history code FM10 on the account. The input of the FM10 sends a message to the Automated Lien System to file an NFTL against the taxpayer. When conditions exist that would allow for manual lien filing, the systemic program can also generate a lien. E-mail from IRS subject matter expert (Nov. 2, 2009); IRS response (Nov. 19, 2009). *See also* IRM 5.19.5.3.7, *Reminder Notices* (Dec. 1, 2007); IRM 5.19.5.5.7, *R7 – Lien Determinations (Follow-Up to LT39)* (May 29, 2008).

35 RRA 98, Title III, § 3421, Pub. L. No. 105-206, 112 Stat. 758 (1998).

36 *See, e.g.*, IRM 5350, *Lien for Taxes* (Nov. 15, 1985).

37 *See* S. Rep. No. 105-174, at 78 (1998). The provision will preclude the IRS from "abusively us[ing] its liens-and-seizure authority." Unanimous Consent Request - H.R. 2676, 143 Cong. Rec. S12230-02, at S12231 (statement of Senator Roth).

38 RRA 98, Title III, § 3421(b), Pub. L. No. 105-206, 112 Stat. 758 (1998).

39 RRA 98, Title III, § 3421(a)(2), Pub. L. No. 105-206, 112 Stat. 758 (1998).

40 H.R. Rep. No. 105-599, at 277 (1998) (Conf. Rep.).

41 Memorandum from Assistant Commissioner (Collection) (July 30, 1998) (concluding section 3421 does not require supervisory review of all collection actions but allows the IRS discretion to determine where such review would be appropriate); Memorandum to Counsel to the National Taxpayer Advocate from Chief, Branch 1, General Litigation Division, Ref. No. GL-122444-98 (Dec. 23, 1998) (same). *See also* IRM 5.12.2.5 (Feb. 1,2007); IRM 5.12.2.5.1 (Feb.1, 2007); IRM 5.12.2.5.2 (Mar. 1, 2004).

42 IRS, Collection Activity Report NO-5000-C23, *Collection Workload Indicators Reports* (Oct. 13, 2009).

43 E-mail from former IRS Chief Compliance Officer to the National Taxpayer Advocate (Nov. 2, 2009) (on file with TAS).

44 Delegation Order 5-4, IRM 1.2.44.4 (Sept. 23, 2005); IRM 5.19.4.5.1(7) (Apr. 28, 2009). All 3,157 ACS employees who had the delegated authority to file NFTLs were GS-6 or higher as of September 30, 2009. IRS response to TAS research request (Oct. 30, 2009).

By contrast, all ACS employees, regardless of grade level, are required to obtain managerial approval if they determine *not* to file a lien.[45] Any such decision must be supported by a case history entry clearly stating the reason why filing a lien will hamper collection or is not proper (*e.g.*, because of doubt as to liability).[46] Similarly, the IRS recently issued interim guidance requiring *all* ROs to obtain managerial approval to *defer* filing a lien for certain employment tax cases in which the unpaid balance is $5,000 or more.[47] Thus, the IRS requires employees to take extra steps and offer additional justification to avoid filing a lien but does not require employees to verify whether the lien attaches to assets or undertake a review of the taxpayer's financial or personal circumstances to determine whether the lien will be productive.

In essence, IRS procedures have flipped Congress's explicit presumptions. Whereas Congress generally directed that IRS employees should obtain managerial approval when they intend to file an NFTL, the IRS now imposes more rigorous managerial approval requirements when an employee determines not to file an NFTL. The IRS should revise its managerial approval procedures to substantively comply with the intent of RRA 98.[48]

The IRS does not verify the existence of assets prior to filing an NFTL.

As noted above, an NFTL protects the government's interests in a taxpayer's property against subsequent purchasers, secured creditors, and junior lien holders when past due taxes are owed.[49] However, the IRS generally does not verify the existence or the value of the taxpayer's property before filing an NFTL, nor does it determine whether the taxpayer is likely to acquire assets in the future. The IRS could easily ascertain whether taxpayers have assets before filing a lien. Most assets, such as real estate, business property, and motor vehicles are reflected on Accurint, a service provided by Lexis-Nexis, with which the IRS has an unlimited annually renewable contract.[50] Simply checking this database would not

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45 IRM 5.19.4.5.2 (10) (Apr. 26, 2006).

46 *Id.*

47 SB/SE, *Interim Guidance Memorandum*, Control No. SBSE-05-1208-069 (Dec. 22, 2008). The IRS issued this guidance in an attempt to implement a Government Accountability Office (GAO) recommendation to timely file NFTLs in federal employment tax cases based on an assumption that filing the NFTL will increase the likelihood of collection. *See* GAO, GAO-08-617, *Tax Compliance, Businesses Owe Billions in Federal Payroll Taxes 31* (July 2008). *See also* TAS analysis of collection yields compared to the number of liens filed in Chart 1.2.1, *Inflation Adjusted Collection Yield and NFTL's Filed, FY 1999 - FY 2009*, *supra*.

48 Section 3421(a) of RRA 98, *Approval Process for Liens, Levies, and Seizures*, specifically states:

(a) IN GENERAL.-The Commissioner of Internal Revenue shall develop and implement procedures under which

(1) a determination by an employee to file a notice of lien or levy with respect to, or to levy or seize, any property or right to property would, where appropriate, be required to be reviewed by a supervisor of the employee before the action was taken, and

(2) appropriate disciplinary action would be taken against the employee or supervisor where the procedures under paragraph (1) were not followed.

(b) REVIEW PROCESS -The review process under subsection (a)(1) may include a certification that the employee has-

(1) reviewed the taxpayer's information,

(2) verified that a balance is due, and

(3) affirmed that the action proposed to be taken is appropriate given the taxpayer's circumstances, considering the amount due and the value of the property or right to property.

49 IRC §§ 6321 and 6323.

50 *See* Accurint, http://www.accurint.com (last visited Oct. 12, 2009).

only increase the effectiveness of liens without unnecessary damage to the taxpayer's credit but could also save on NFTL mailing expenses and court filing fees. Alternatively, the IRS should develop an algorithm to identify whether a taxpayer has assets by using internal sources, such as its own Information Returns Program (IRP) data, which provides verifiable payee/payer documentation.[51]

IRS lien policy unnecessarily harms taxpayers who are currently unable to pay and does not generate increased collection revenue.

If the taxpayer owes over $5,000 and the account is reported as currently not collectible, the IRS will file an NFTL, in many cases systemically, without any determination about whether the taxpayer has or is likely to acquire any assets to which a lien could attach.[52] The IRM requires NFTL filing for CNC accounts both when the IRS cannot locate or contact the taxpayer and when the taxpayer is experiencing an economic hardship.[53] Even though in many cases an IRS employee may have talked to the taxpayer and evaluated his or her financial information or other evidence of financial difficulty (including a medical hardship) prior to reporting the taxpayer's account as CNC (*i.e.*, unable to pay), the IRS has replaced its employees' judgment and discretion with a business rule that requires NFTL filing.[54]

A TAS analysis of collection payment data from a subset of taxpayers in CNC (hardship) status also shows that only about five percent of all payment transactions and approximately 20 percent of the total dollars collected from these taxpayers are attributable to NFTLs, as shown in Chart 1.2.4 below.[55] At the same time, refund offsets — which do not require an NFTL — comprise about 59 percent of the total dollars collected and about half of all payment transactions for this taxpayer population.[56]

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51 IRM 2.3.35.1 (Aug. 1, 2003). The IRP allows IRS employees to request either online or hardcopy Information Returns Processing transcripts from the Information Returns Master File (IRMF), *e.g.*, from such information returns as Form 1098, *Mortgage Interest Statement* (demonstrating home ownership) or Form 1099-INT, *Interest Statement*, and its progeny (demonstrating assets).

52 IRM 5.12.2.4.1 (1) (May 20, 2005). IRS Policy Statement P-5-71 provides the IRS authority to report an account as currently not collectible for a variety of reasons (*e.g.*, unable to pay (hardship), unable to contact or locate, and death). This generally suspends collection actions but the liability is still due and owing; thus, penalties and interest continue to accrue until the statutory period of collection expires. "Economic hardship" occurs when an individual taxpayer is unable to pay reasonable basic living expenses. *See* Treas. Reg. § 301.6343-1(b)(4).

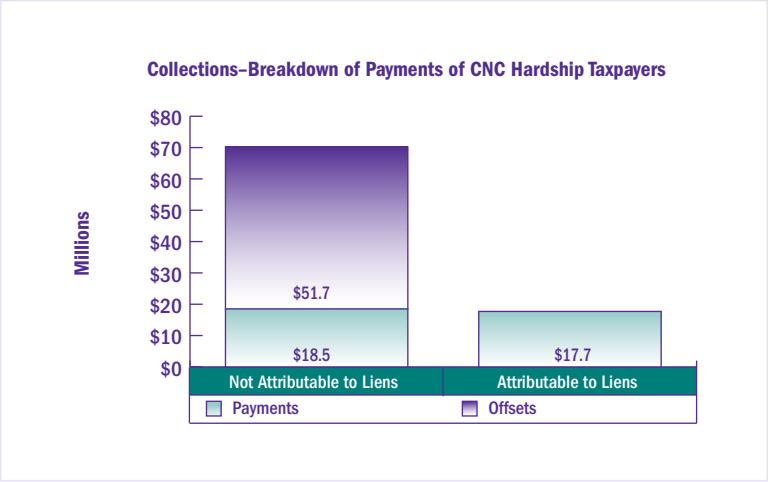
53 IRM 5.19.4.5.2 (Aug. 4, 2009).

54 Policy Statement P-5-71, IRM 1.2.14.1.14 (Nov. 19, 1980). *See also* IRM 5.16.1.1, *Currently Not Collectible Policy and Procedure Overview* (May 5, 2009); IRM 5.16.1.2.9, *Hardship* (May 5, 2009). The basis for a hardship determination is from information about the taxpayer's financial condition provided on Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals*, or Form 433-B, *Collection Information Statement for Businesses*. *See also* IRM 5.15.1, *Financial Analysis Handbook* (Oct. 2, 2009).

55 TAS pulled a subset of CNC Hardship taxpayers from the 270,399 individual taxpayers who first incurred new balance due delinquencies in TY 2002, had no previous unpaid tax liabilities at that time, and against whom NFTLs were filed in subsequent years (discussed above). This analysis is based on the subset of payments that were refund offsets or had specific DPC coding. It does not include those payments that were coded as "Miscellaneous" or had no DPC coding. IRS, CDW, IMF Transaction File Cycle 200913.

56 Pursuant to IRC § 6402(a), the IRS may credit a taxpayer's overpayment to any federal tax liability prior to making a refund. This application of a tax overpayment is called a refund offset.

CHART 1.2.4, Total Dollars Collected – Breakdown of Payments of CNC Hardship Individual Taxpayers[57]



As noted above, automatic NFTL filing on CNC (hardship) taxpayers exacerbates their financial difficulties. Thus, the IRS should eliminate automatic NFTL filing in these cases, and instead require its employees to base filing determinations on a thorough review of the taxpayer's circumstances (including the existence and the value of assets, the taxpayer's financial information, and the effect of the lien on the taxpayer's credit rating).[58] This determination should be made after personal contact with the taxpayer and a substantive consideration of the facts, which may include consultation with a manager.[59] Moreover, this expectation should be applicable to all IRS contact employees, ACS and revenue officers alike. Human intervention, *i.e.*, the application of employee discretion and judgment prior to making a lien determination, is paramount.

IRS failure to fully utilize its statutory authority to withdraw NFTLs harms taxpayers and impairs collection of debts and future compliance.

The IRS may withdraw an NFTL if:

1. The NFTL was filed prematurely or otherwise not in accordance with IRS procedures;
2. The taxpayer entered into an installment agreement (IA) to satisfy the liability (unless the IA provides otherwise);

57 TAS pulled a subset of CNC Hardship taxpayers from the 270,399 individual taxpayers who first incurred new balance due delinquencies in TY 2002, had no previous unpaid tax liabilities at that time, and against whom NFTLs were filed in subsequent years (discussed above). This analysis is based on the subset of payments that were refund offsets or had specific DPC coding. It does not include those payments that were coded as "Miscellaneous" or had no DPC coding. IRS, CDW, IMF Transaction File Cycle 200913.

58 Low Income Taxpayer Clinics (LITCs) report they are dealing with an increasing number of taxpayers who have lost their jobs during the economic downturn and were placed in CNC status. However, the IRS has liens in place for these taxpayers, who want to work but are having difficulty finding employment due to the lien. American Bar Association Section of Taxation LITC listserv submission (Nov. 4, 2009).

59 IRS Policy Statement 5-47 indicates that notices of lien will generally only be filed after the IRS contacts the taxpayer in person, by telephone, or by notice. IRM 1.2.14.1.13 (Oct. 9, 1996). A personal contact (in person or by telephone) is preferred but not required. IRM 5.12.2.3 (May 20, 2005). The National Taxpayer Advocate notes that the implementation of business rule-driven, systemic lien filing renders these policies meaningless.

3. The withdrawal would facilitate collection; or
4. The withdrawal is in the best interests of the taxpayer (as determined by the National Taxpayer Advocate) and the United States.[60]

However, the withdrawal of an NFTL will not affect the underlying FTL,[61] and thus provides the IRS a discretionary mechanism for withdrawing the notice of lien when release of the lien itself is not an option because the requirements for release have not been met.[62]

The withdrawal provisions of IRC § 6323(j) were enacted as part of the Taxpayer Bill of Rights 2 (TBOR 2) in 1996.[63] Until then, the IRS had no authority to withdraw NFTLs.[64] In proposing lien withdrawal authority, the House Committee Report noted that "[t]he bill allows the IRS to withdraw a public notice of tax lien prior to payment in full by the indebted taxpayer without prejudice, if the Secretary determines that" one of the four listed criteria is met.[65]

The difference between a "lien withdrawal" and a "lien release" is significant and is not well understood. When credit reporting agencies receive notice of a "withdrawal" of an NFTL, they delete any references to the tax lien from the taxpayer's credit history.[66] In contrast, an NFTL that is "released" typically remains on the taxpayer's credit report for seven years from the date of the release.[67] As a recent memorandum from the Office of Chief Counsel noted,

> [E]ven though a taxpayer has fully paid the tax and a certificate of release has been filed, the fact that the NFTL was filed in the first place can adversely affect the taxpayer's credit history for years after the tax is paid. In contrast, if the IRS files

60 IRC § 6323(j); Treas. Reg. § 301.6323(j)(b)(5).

61 Treas. Reg. § 301.6323(j)-1(a).

62 IRC §§ 6323(j)(1); 6325(a). A lien can be released if the liability has been satisfied or become unenforceable or the taxpayer has posted a bond.

63 TBOR 2, Pub. L. No. 104-168, Title V, § 501(a), 110 Stat. 1452 (1996).

64 H.R. Rep. No. 104-506, 32-33 (1996), reprinted in 1996 USCCAN 1143, 1155-1156.

65 *Id.* While the legislative history of TBOR 2 does not specifically explain lien withdrawal criteria, a number of congressional hearings preceding TBOR 1 (which initially contained the same lien withdrawal provision) suggest that Congress intended lien withdrawal to be a collection alternative for taxpayers experiencing economic hardship. *Taxpayer Bill of Rights, Hearing Before the Subcomm. on Private Retirement Plans and Oversight of the Internal Revenue Service of the S. Comm. on Finance*, 100th Cong., 1st Sess. (Apr. 10 and 21, 1987)(statement of Jack Warren Wade, National Taxpayers Union). *See also* statement of Senator Carl Levin (June 22, 1987); *Report on Internal Revenue Service Collection Practices, Impact on Small Businesses, Subcomm. on Oversight of Government Management of the S. Comm. on Governmental Affairs*, 96th Cong., 2d Sess. (Oct. 9, 1980).

66 TAS teleconferences with the major consumer reporting agencies (CRAs) – Experian (Oct. 1, 2009), Equifax (Sept. 1, 2009), and Transunion (Sept. 3, 2009). IRC § 6323(j)(1) provides "this chapter [chapter 64 of subtitle F, relating to collection] shall be applied as if the withdrawn notice had not been filed." *See also* Treas. Reg. § 301.6323(j)-1(a). The IRS should promptly notify credit reporting agencies and financial institutions or creditors identified by the taxpayer of the withdrawal of the notice upon a written request. IRC § 6323(j)(2).

67 FCRA § 605(3), 15 USC § 1681c(a)(3). The FCRA regulates consumer reporting agencies and provides limitations to the age of particular types of credit information that may be reported. Paid (and therefore released) tax liens are reported for seven years from the date of payment. *See also* Phillip C. Hong-Barco, *How the Fair Credit Reporting Act Fails to Protect: The Case of IRS Tax Liens on Consumer Credit Reports*, 3 Pitt. Tax. Rev. 181, 191-193 (Spring 2006).

> a withdrawal of the NFTL, from a credit rating standpoint it is as if the NFTL was never filed.[68]

In the last several years, the National Taxpayer Advocate has observed a resistance on the part of IRS Collection personnel to withdrawing NFTLs, notwithstanding Congress' express grant of such discretionary authority. She has had conversations with executives at the highest levels of IRS Collection leadership who have indicated a belief that NFTL withdrawal should occur only "where the IRS has made a mistake," that NFTL withdrawal is "an admission of guilt," and that training Collection employees about circumstances under which NFTL withdrawal would be appropriate "will confuse Collection employees and result in [their] not filing liens." Moreover, the IRS has developed an NFTL withdrawal policy that does not allow a taxpayer to obtain a withdrawal after a lien release, and this policy may harm taxpayers. The concept that the IRS could not withdraw an NFTL after filing a release was first introduced in the IRM in 2003, although that provision still specifically authorized withdrawals "if one or more of the four withdrawal provisions is met."[69] Subsequent revisions of the IRM preclude the withdrawal of the NFTL after lien release, even when criteria for lien withdrawal are met.[70] In FY 2009, the National Taxpayer Advocate and Local Taxpayer Advocates (LTAs) issued eight Taxpayer Assistance Orders (TAOs) regarding IRS lien filing policies, five of which specifically ordered the IRS to withdraw NFTLs.[71] The IRS responses to these TAOs demonstrate a lack of understanding of the statutory authority for NFTL withdrawals contemplated by Congress in TBOR 2.[72]

At the request of the National Taxpayer Advocate, the IRS Office of Chief Counsel has recently reevaluated its legal position and now concludes "that as a legal matter, the IRS may file a certificate of withdrawal after a lien release."[73] Since the IRS can only withdraw an NFTL if one of the four criteria in IRC § 6323(j) is met, the taxpayer must persuade the IRS that withdrawal is both in the taxpayer's and the government's best interests. Given the long-term effects of the NFTL release on the taxpayer's credit report – the likelihood that the taxpayer could face higher interest rates, denial of credit or employment, or even job loss – it will often facilitate tax compliance and be in the government's best interests to withdraw an NFTL post-release. Indeed, it will be a rare instance in which post-release NFTL withdrawal would *not* be in the government's best interests. Thus, the IRS should issue interim guidance which allows, upon the request of a taxpayer, for the IRS to withdraw

68 Memorandum from Branch 3 (Procedure and Administration) to Special Counsel (National Taxpayer Advocate), Ref. No. POSTN-133674-09 (Oct. 8, 2009). TAS teleconferences with the major CRAs – Experian (Oct. 1, 2009), Equifax (Sept. 1, 2009), and Transunion (Sept. 3, 2009).

69 IRM 5.12.3.26.1 (2) (July 15, 2003).

70 IRM 5.12.3.26.1(2) and (3) (July 15, 2003). In a 2006 revision of the IRM, the IRS revised its NFTL withdrawal procedures to specifically reject requests for the withdrawal of the NFTL after lien release, even when criteria for lien withdrawal are met. IRM 5.12.3.37 (1) (Sept. 7, 2006).

71 In FY 2009, the National Taxpayer Advocate and Local Taxpayer Advocates (LTAs) issued a total of 45 Taxpayer Assistance Orders (TAOs).

72 In one recent case, the TAO was returned to the LTA for reconsideration because the manager believed that to withdraw an NFTL, the taxpayer had to meet all four of the provisions under IRC § 6323(j) instead of meeting only one. The taxpayer signed a written consent allowing TAS to release this tax return information.

73 Memorandum from Branch 3 (Procedure and Administration) to Special Counsel (National Taxpayer Advocate), Ref. No. POSTN-133674-09 (Oct. 8, 2009).

an NFTL where one of the statutory criteria is satisfied, even if the underlying lien has been released.[74]

The IRS should also include the potential for NFTL withdrawal as part of the collection analysis for a taxpayer. If the taxpayer cannot find a good job, or his or her credit is destroyed, that taxpayer may never return to compliance. We also recommend that SB/SE and the Wage and Investment (W&I) division partner with TAS to develop guidance and conduct training for IRS Collection personnel in both the Collection Field function and the ACS about lien withdrawals.[75]

CONCLUSION

The IRS measures the number of liens filed each year but does not measure whether public filing of liens makes a difference in a taxpayer's compliance behavior over time. By measuring and reporting on the number of liens filed and by not measuring or reporting on their long-term compliance effect, the IRS overstates the effectiveness of liens and sends a message to its employees that the quantity, not the quality, of liens is what matters.

The National Taxpayer Advocate offers these preliminary recommendations:

1. Immediately implement quality review of Designated Payment Codes.
2. Adopt two long-term effectiveness measures to ensure that employees file appropriate and productive NFTLs. First, the IRS should measure the total and average revenue (dollars collected) attributable to NFTL filings. Second, it should measure the long-term impact of the NFTL on the taxpayer's compliance behavior.[76]
3. Abandon the policy of automatic NFTL filing on CNC hardship accounts with an unpaid balance of $5,000 or more.
4. Implement the provisions of RRA 98 § 3421 by basing lien filing determinations for all IRS contact employees on a thorough review of all the taxpayer's circumstances (including the existence and the value of assets, the taxpayer's financial information, and the ramifications of the lien on the taxpayer's credit rating), after an in-person or telephone interview with the taxpayer and substantive consideration of the facts, which may include consultation with a manager.
5. Require managerial approval for NFTL filings in all cases where the taxpayer has no assets, regardless of the employee's grade level.

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[74] *See Legislative Recommendation: Strengthen Taxpayer Protections in the Filing and Reporting of Federal Tax Liens, infra.*

[75] TAS has already developed a training video on taxpayer rights and collection with five case studies, including one on lien withdrawal. We have offered to distribute this video to Revenue Officer groups throughout the IRS and to assist in facilitating the training sessions. TAS training video, *Taxpayer Rights: Collection Case Studies.*

[76] *See* Nina E. Olson, *Minding the Gap: A Ten-Step Program for Better Tax Compliance*, 20 Stan. L. & Pol'y Rev. 7, 23 (2009).

6. Revise the IRM to allow, upon the request of a taxpayer, the withdrawal of an NFTL where the statutory withdrawal criteria are satisfied, even if the underlying lien has been released.
7. Conduct annual training for collection employees and managers in exercising judgment and discretion before and after NFTL filing, and include the TAS training video, *Taxpayer Rights: Collection Case Studies,* as part of the training.

IRS COMMENTS

As the National Taxpayer Advocate has acknowledged, the NFTL can be an effective tool in tax collection. The purpose of the NFTL is to protect the government's priority over other creditors. In filing an NFTL, the IRS is perfecting an existing lien interest, relative to other creditors, for unpaid federal tax liabilities. Establishing and preserving our priority over other creditors is especially critical when a taxpayer's liabilities exceed their assets and not all debts can be satisfied.

The presence of an NFTL when a taxpayer files bankruptcy can significantly impact the amount of revenue the government receives in a bankruptcy proceeding. The presence of an NFTL gives the IRS a secured claim and a greater potential to collect on its proof of claim. This improves the government's position in competing with other creditors for payment from limited income and assets.

The National Taxpayer Advocate conducted an internal research study on the effectiveness of the NFTL. The IRS believes the methodology used to conduct this study limits the ability to draw meaningful conclusions.[77] The National Taxpayer Advocate's methodology examined trends in lien filing and dollars collected without regard to other variables that may occur over the life of the study. Changes to economic conditions, the inventory mix, and collection business practices and structure all can influence dollars collected. Further, the National Taxpayer Advocate assesses the value of the NFTL based only on those transactions that can be identified by a DPC.[78] To credit the influence of the NFTL only to those payments with transactions specifically made to acquire a release, discharge, withdrawal, or subordination of the lien does not provide a complete picture of the impact of the NFTL. In the sample used by the National Taxpayer Advocate, 56 percent of the transactions received were excluded due to lack of a DPC; this exclusion can have a significant impact on the results and the related analysis. Taxpayer actions such as making installment payments, filing an offer in compromise, or paying the liability in full may be motivated by the anticipation of the filing of or an already filed NFTL. Given the above limitations, the National Taxpayer Advocate study on the effectiveness of the NFTL provides a very

[77] TAS reviewed 2,065,303 transactions from 270,399 individual taxpayers. For a more detailed discussion, see *The IRS's Use of Notices of Federal Tax Lien (NFTL)*, vol. 2, *infra.*

[78] *See* IRM 5.1.2.8.1 (Aug. 15, 2008). These two-digit numeric codes are called Designated Payment Codes. The DPCs are used to help identify payments, indicate application of payment to a specific liability, and identify the event that resulted in a payment.

conservative estimate for the amount collected as a result of some very specific lien related transactions.

The IRS has conducted and is conducting several research efforts on the impact and effectiveness of tax liens. Our research efforts attempt to control for variables and include all transactions. While not conclusive, the results illustrate the efficacy of liens in various circumstances. Since 2002, IRS Research has completed four independent, statistically valid studies on this topic.[79]

In 2006, Research found that filing a lien on systemically shelved cases had little effect *unless the balance was over $5,000*. This is one of the same criteria used by IRS Collection in mandatory consideration of lien filing. The study found that:

> "Based on the results from the regression model: **for cases with balances between $5,000 and $25,000 and having a lien filed, the balance due one year after the lien was filed would be, on average, 28 percent lower than if no lien was filed."** (Emphasis in original.)[80]

In another study completed in 2002, Research determined that a ten percent increase in lien filing would result in an increase in collections of $3.99 billion. Research also found that "Liens should generally be filed even when assets have not been identified."[81]

The IRS maintains, as supported by the 2002 Research study, filing an NFTL, even in situations when assets have not been identified, is a prudent case decision because the NFTL attaches to a taxpayer's right, title, and interest in current and future property. Thus, even though an account may be placed in currently not collectible status without any current assets from which to collect the tax liability, there remains solid evidence that filing the NFTL is the most responsible and appropriate action the IRS can take in its effort to ensure sound tax administration. There are multiple situations in which the IRS may designate a taxpayer's account currently not collectible, including an inability to make payments based on current income and expenses; or the IRS's inability to locate or contact the taxpayer. However, a taxpayer's situation can, and often does, change. A filed NFTL provides the government a claim in any future income or assets that would allow for payment of the outstanding tax liability. When a lien is filed in these situations, the taxpayer may contact the IRS to resolve the liability when trying to sell or liquidate the asset—an asset that the IRS may not have known about or was acquired after the filing of the lien.

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79 SB/SE Research – St. Paul, Project 13.14, *Estimating the Impact of Federal Tax Lien Filing on Accounts Receivable Resolution* (Dec. 2002) (hereinafter 2002 study); SB/SE Research – St. Paul, Project STP0001, *Impact of the Federal Tax Lien on Cases Shelved by the Currently Not Collectible Filter* (June 2006) (hereinafter 2006 study); SB/SE Research – St. Paul, Project STP0007, *Optimizing the Revenue Collection Impact of Lien Refiling* (Mar. 2007) (hereinafter 2007 study); Turk, Alex and Terry Ashley, 2002, "Accounts Receivable Resolution and The Impact of Lien Filing Policy on Sole Proprietor Businesses," *Federal Forecasters Conference 2002 – Papers and Proceedings*, 323-332; SB/SE Research – Denver, Project DEN0113.

80 SB/SE Research – St. Paul, 2006 study.

81 SB/SE Research – St. Paul, 2002 study.

The IRS does not report tax debts or the filing of NFTLs to credit reporting agencies. Those agencies receive notification of public lien filing through third party vendors and report that information on consumer credit reports. IRS decisions regarding the filing, release, and withdrawal of liens must be based on the need to protect the priority of the government and to secure payment.

The IRS recognizes the need to ensure liens are filed based on the most accurate information known at the time of filing. The amount owed and all other pertinent information available at the time are considered as part of the determination to file an NFTL. Additionally, in those situations when it is appropriate, managerial approval is required prior to filing a lien. In the Restructuring and Reform Act of 1998 (RRA 98), Congress directed the IRS to develop and implement procedures for supervisory review and approval, where appropriate, of liens, levies, and seizures. The Conference Agreement from RRA 98 § 3421 states as follows:

> "The conference agreement follows the Senate amendment. The conferees *intend that the Commissioner have discretion* in promulgating the procedures required by this provision to determine the circumstances under which supervisory review of liens or levies issued by the automated collection system is or is not appropriate." (Emphasis added.)[82]

In accordance with § 3421, the IRS has used discretion to ensure that authorities are based on the training and experience of the employee and the type of case at issue; not the pay grade of the employee. For example, grade 6 employees in ACS have completed their initial training and have attained the full working level of their position. At the grade 7 level, revenue officers are still in training status and require oversight from a coach or manager. The cases worked in these two different work streams differ in complexity and risk, which drives whether managerial oversight of certain decisions, including lien filing determinations, is required.

The IRS has a responsibility to review each application for lien withdrawal and, using discretion, weigh appropriate tax administration considerations in determining whether or not to withdraw a filed NFTL. Section 6323(j) authorizes withdrawal when one of four conditions is met; however, the decision to withdraw an NFTL is discretionary. The IRS will consult with the Office of Chief Counsel and revise the IRM to provide guidance on when withdrawal of an NFTL is appropriate in cases in which the lien has already been released.

The National Taxpayer Advocate makes seven preliminary recommendations. In response, the IRS has taken, or is taking, the following actions with respect to these recommendations:

82 IRS Restructuring and Reform Act of 1998, Pub. L. 105-206, Conf. Report, H.R. 2676, 105th Congress 2d Sess. 278.

The IRS recognizes the need to ensure the consistent and appropriate use of Designated Payment Codes by employees. We will review our guidance in this context for clarity to ensure employees understand the need to properly code payments received.

The IRS has initiated several research studies to determine the effectiveness of lien filing. We will continue to utilize the findings from these and future studies when considering IRM and policy changes to ensure employees are filing appropriate and productive NFTLs.

The IRS does not have an automatic NFTL filing policy on CNC hardship accounts. A lien determination is required when closing an account CNC hardship with an unpaid balance of $5,000 or more. As part of the lien determination, an employee may decide that a lien should not be filed due to individual taxpayer circumstances.[83]

The IRS believes we provide adequate guidance and training to our employees to allow them to make appropriate lien determinations.[84] Employees are expected to ensure liens are filed based on the most accurate information known at the time of filing. The amount owed and all other pertinent information available at the time are considered as part of the determination to file an NFTL.

Given that the NFTL attaches to a taxpayer's right, title, and interest in current and future property, we do not believe it is appropriate to require managerial approval for NFTL filings on all cases where the taxpayer has no current assets.

A taxpayer's situation can, and often does, change and a filed NFTL provides the government a claim in any future income or assets that would allow for payment of the outstanding tax liability.

The IRS will consult with the Office of Chief Counsel on their interpretation of IRC § 6323(j) and, consistent with their advice, revise the IRM to provide guidance on when withdrawal of an NFTL is appropriate in cases in which the lien has already been released.

The IRS believes current training efforts and updates are sufficient to convey IRS policy with regard to lien determinations.[85] The collection function frequently revisits this topic in Continuing Professional Education sessions.

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83 *See* IRM 5.12.2.4, *Notice of Federal Tax Lien Determination* (Oct. 30, 2009); IRM 5.19.4.5.2, *Lien Filing Determinations* (Apr. 28, 2009).

84 *Id*.

85 ROs receive training on lien filing determinations as part of revenue officer Unit 1 training - Course 15829; ACS employees receive training on lien filing determinations in ACS Basic Training - Liens Course 18753.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate agrees that the notice of federal tax lien can be an effective tool in tax collection, when used appropriately. Congress conveyed federal tax lien powers onto the IRS to protect the government's interest in the taxpayer's property and afford it priority status over other creditors. In a recent collection training video, the IRS Collection function director recognizes that "no other country appears to have a tool similar to the Notice of Federal Tax Lien. In other countries, tax administration agencies have to initiate some type of lengthy litigation in order to document the debt."[86] However, with great powers comes great responsibility. The NFTL filing and the information contained on the notice are available on consumer (credit) reports[87] and therefore may impair a taxpayer's ability to obtain financing, find or keep a job, and secure affordable housing or insurance. When a taxpayer has little or no ability to pay and has no assets from which to collect, an NFTL filing may significantly impede the taxpayer's financial viability and ultimately undermine long-term tax revenue and future compliance.

In addition, the government has a secondary interest at stake. If the NFTL damages the taxpayer and the taxpayer's family by driving up the taxpayer's costs or rendering him or her unemployed or underemployed, the government may be forced to provide a social safety net in the form of unemployment benefits, food stamps, and the like, thus increasing societal cost and raising everyone's share of taxes. For these reasons, the IRS should only employ this powerful tool after attempting to contact the taxpayer personally and considering *all* of the taxpayer's specific facts and circumstances. This analysis should include the existence and the value of and equity in assets, the taxpayer's financial information including other debts, and the ramifications of the lien on the taxpayer's credit rating, including the taxpayer's ability to comply with current and future tax obligations.

The National Taxpayer Advocate is disappointed by the IRS's insistence that filing an NFTL is a necessity on all cases and that this act will increase compliance and yield more revenue. This is troubling because the IRS's own data suggest otherwise. Although the IRS proudly boasts that in one of its 2002 research studies "a ten percent increase in lien filing would result in an increase in collections of $3.99 billion," the actual numbers tell a much different story. As we stated earlier, over the past decade, the IRS has increased its lien filings by nearly 475 percent – from about 168,000 in FY 1999 to nearly 966,000 in FY 2009.[88] Yet

86 David Alito, Director, Collection, SB/SE, Training Video, *Focusing on the Basics*, http://sbse.web.irs.gov/cl2/sl/ivt/csk/Collection/0358/default.htm (last visited Dec. 16, 2009)(referring to Australia, Canada, New Zealand, and Great Britain).

87 The term "consumer report" is defined in the FCRA, § 603(d), 15 USC § 1681a(d). Hereinafter, we will use the more commonly used term "credit report." On average, the filing of an NFTL reduces a taxpayer's credit score by 100 points. Written response from Vantage Score® (Sept. 17, 2009). The impact of the NFTL filing is greatest upon the initial filing and diminishes over time.

88 IRS, *SOI Data Books, Table 16, Delinquent Collection Activities, 1999-2008*; IRS, Collection Activity Report NO-5000-C23, *Collection Workload Indicators Reports* (Oct. 13, 2009). In FY 2009, the IRS filed 965,618 NFTLs.

overall inflation-adjusted Collection revenue has declined by approximately 7.4 percent during this period.[89]

The IRS 2006 lien study covered only about 8,000 CNC "shelved" cases out of over a half million Forms 1040 reported as CNC by the IRS in 2003.[90] While the study report suggests that filing liens on CNC cases in the $5,000 to $25,000 balance due range could be beneficial, particularly if the threshold for shelving cases is lowered, the average difference in payment amounts between those study cases with and without a lien was only $130. Moreover, the study considered all payments to a tax module even though some payments may have been offsets of a taxpayer's subsequent refund and in no way attributable to the lien. In addition, the National Taxpayer Advocate is concerned that the study does not analyze lien filings on many other types of cases. Clearly, the lien study recommendations cited by the IRS missed the mark.[91]

Moreover, the IRS has failed to acknowledge these inaccuracies and instead continues to rest its lien filing policies and procedures on similarly misguided or outdated data.[92] The initial models in the studies show that NFTLs actually decrease resolution.[93] The studies attribute this decline to a substantial variation in the way IRS uses NFTLs. Further the models account for this variation and show that NFTLs increase resolution (in certain scenarios) as they expected. *On the contrary, TAS's study made no assumptions on the effect of NFTLs on resolution and just observed the data that show that NFTLs could not be proven to be effective in our study population.*

TAS's analysis indicated that in approximately 52 percent of all payment transactions, the IRS coded the payments as "Miscellaneous" or did not code them at all.[94] The remaining 48.4 percent had meaningful DPCs or could be identified as refund offsets.[95] Although the IRS is correct in stating that a portion of the "Miscellaneous" or uncoded payments may

89 IRS, *SOI Data Books, Table 16, Delinquent Collection Activities, 1999-2008*. SB/SE response to TAS research request (Nov. 13, 2009). The SOI data is not available for FY 2009. For a more detailed discussion of IRS Collection data, see *Preface: Introductory Comments of the National Taxpayer Advocate, supra.*

90 In 2003, IRS Collection function implemented computer filters that classified certain cases as being in CNC status. Cases selected by the filters are placed in the shelved status and are not worked.

91 SB/SE Research – St. Paul, 2002 study; SB/SE Research – St. Paul, 2006 study; SB/SE Research – St. Paul, 2007 study.

92 For example, the 2002 study is based on 1999 data.

93 For example, the 2002 study states: "[o]ne should keep in mind that, since other factors are not being controlled, we cannot conclude that any difference is because of the lien." SB/SE Research – St. Paul, 2002 study, 12. We note that this is the very same "flaw" that the IRS uses to criticize the 2009 TAS research study discussed herein.

94 IRS, CDW, IMF Transaction File Cycle 200913. Of the 1,886,683 total payment transactions, only 629,158 transactions had the DPC code assigned. 1,257,525 transactions were designated "miscellaneous" or "DPC indicator not present." Of the 1,257,525 transactions, 283,091 had a refund offset transaction code, leaving 974,434 payments (or 51.6 percent) as unaccountable. Thus, 912,249 payments (or 48.4 percent) had meaningful DPCs or could be identified as refund offsets. *See also* Chart 1.2.2, *Dollars Collected Attributable to Liens Filed Against TY 2002 Individual Taxpayer Liability and Subsequent Payments from CY 2002 to CY 2009, supra*. The IRS does not conduct a quality review of the payment information by DPC. IRS response to TAS research request (Oct. 6, 2009).

95 TAS reviewed 1,886,683 transactions from 270,399 individual taxpayers. For a more detailed discussion and description of this lien analysis and methodology, including payment allocation, see *The IRS's Use of Notices of Federal Tax Lien (NFTL)*, vol. 2, *infra*. It should be noted that we reconstructed the 48.4 percent total so that it included offsets. In 51.6 percent of the transactions, neither TAS nor the IRS can identify the source of payment.

have been associated with an NFTL filing, in the absence of mechanisms to account for the source of payment neither TAS nor the IRS can speculate to what extent such payments are attributable to NFTL filings. We partially agree with the IRS's assertion that TAS findings provide a conservative estimate for the amount collected as a result of lien-related transactions. However, the conservatism in our analysis works both ways – *i.e.*, it is just as if not more likely that our findings also significantly understate the amount collected as a result of actions *other than* lien-related transactions. ***Moreover, the conservatism in our analysis is solely attributable to the IRS's failure to accurately and properly code payment transactions. Therefore, we believe that our approach provides the most accurate results.*** In addition, the IRS largely overstates the impact of an NFTL in bankruptcy proceedings on the amount of revenue the IRS receives. FY 2008 data clearly show that the IRS collected more on unsecured priority claims than on secured claims in bankruptcy proceedings.[96]

In its response, the IRS also suggests the decline in dollars collected could be attributable to "changes in economic conditions, the inventory mix, and collection business practices and structure." However, the IRS has not initiated a new study of a statistically valid sample of taxpayers to determine the extent to which the recession may have contributed to the decline in dollars collected, and more importantly, how NFTL filing may affect the taxpayer's ability to pay the tax liability and his or her future tax compliance. Nor has the IRS committed to immediately implement a quality review of Designated Payment Codes as recommended by the National Taxpayer Advocate. The National Taxpayer Advocate insists that the IRS implement quality review of employees' consistent and proper use of DPCs. She also strongly believes that the IRS should conduct a full scale, statistically valid study of NFTL effectiveness, including the total and average revenue (dollars collected) attributable to NFTL filings as well as other sources, and the long-term impact of the NFTL on the taxpayer's compliance behavior.[97] When conducting studies about taxpayer compliance and the effectiveness of liens, the IRS should partner with TAS research function in the design of the studies to ensure that they are framed appropriately to consider the impact on taxpayers' economic viability and long-term tax compliance, not just short-term gains or justifications of current practices.

The National Taxpayer Advocate rejects the IRS's rationale for current lien filing procedures that ensure an NFTL will be filed on most CNC accounts with an unpaid balance of assessment of $5,000 or more.[98] The National Taxpayer Advocate disagrees that "filing the NFTL [in cases reported as CNC] is the most responsible and appropriate action the IRS can take in its effort to ensure sound tax administration." Sound tax administration requires making a careful, case-by-case analysis of a taxpayer's specific facts and circumstances.

96 IRS, Collection Activity Report NO-5000-31, *IMF Report of Bankruptcies* (Sept. 30, 2008). In FY 2008, the total collection for all chapters showed $181,328,355 collected from unsecured priority claims and $57,858,628 collected from secured claims.

97 This study should also analyze the impact of lien filing on individual taxpayers and small businesses by income levels, since there is some evidence that the NFTL is particularly damaging to low income taxpayers and small businesses that already have limited access to credit.

98 IRM 5.12.2.4.1 (Oct. 30, 2009). In general, the IRM requires NFTL filing when "an open account with an aggregate UBA [Unpaid Balance of Assessment] of $5,000 or more is being reported as currently not collectible."

It does not mean an arbitrary, automatic decision, per the IRM, to file an NFTL without consideration of the existence of assets and the likelihood that the taxpayer will acquire assets during the remaining statute of limitations period.

Emphasizing the IRS's discretion in promulgating the language in RRA 98 § 3421, the IRS fails to address the reasons why Congress enacted this provision in the first place. Congress recognized that federal tax liens may impose a serious hardship on taxpayers and wanted to provide an extra layer of protection for these taxpayers.[99] The Senate Report (where this provision was initially introduced) specifically stated:

> ***"The Committee believes that the imposition of liens, levies, and seizures may impose significant hardships on taxpayers. Accordingly, the Committee believes that extra protection in the form of an administrative approval process is appropriate."*** (Emphasis added).[100]

RRA 98 § 3421 introduced an administrative approval process that requires a supervisor to verify that the filing of a lien was appropriate, considering the amount due and the value of the taxpayer's assets. However, the IRS has interpreted this provision as not requiring managerial review of all liens prior to filing in most cases. Further, the current lien filing policies negate the usefulness of any managerial review because the only verification the IRS does before filing a lien is to verify that the amount due is correct.[101]

The National Taxpayer Advocate strongly believes that the IRS should implement meaningful managerial review of lien filing determinations. The determination process should follow the letter and the spirit of law and include a serious effort to make an in-person or telephone interview with the taxpayer, and a substantive consideration of all facts and circumstances, including the existence and the value of assets, the taxpayer's financial information, and the ramifications of the lien on the taxpayer's credit rating and its long-term impact on taxpayer compliance. This process may include a consultation with a manager, "where appropriate." Additionally, since Congress specifically envisioned the managerial review to include the consideration of "value of the property or right to property,"[102] the IRS should require managerial approval for NFTL filings in all cases where the taxpayer has no assets, regardless of the employee's grade level.

The National Taxpayer Advocate is pleased with the IRS's plans to consult with the IRS Office of Chief Counsel on the interpretation of IRC § 6323(j) with respect to withdrawal

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99 RRA 98, Title III, § 3421, Pub. L. No. 105-206, 112 Stat. 758 (1998). *See* S. Rep. No. 105-174, 78 (1998). The provision will preclude the IRS from "abusively us[ing] its liens-and-seizure authority." Unanimous Consent Request - H.R. 2676, 143 Cong. Rec. S12230-02, S12231 (statement of Senator Roth).

100 *See* S. Rep. No. 105-174, at 78 (1998).

101 IRM 5.19.4.6.4(1) (Oct. 26, 2007); IRM 5.19.4.5.2 (Apr. 26, 2006); IRM 5.19.4.5.1(7) & (8) (Dec. 22, 2005); IRM 5.19.5.5.7 (3) (May 29, 2009). For example, when the account is in CNC status, the lien should be filed for any unpaid balance of $5,000 or more and the IRS is unable to locate or contact the taxpayer, or the taxpayer is experiencing an economic hardship. IRM 5.12.2.4.1(1) (May 20, 2005); IRM 5.19.4.5.2 (Aug. 4, 2009).

102 RRA 98, Title III, § 3421, Pub. L. No. 105-206, 112 Stat. 758 (1998).

of NFTLs. However, given the significant financial hardship that NFTLs may impose on affected taxpayers, and the recent Chief Counsel conclusion "that as a legal matter, the IRS may file a certificate of withdrawal after a lien release,"[103] the IRS should immediately issue interim guidance to its employees regarding NFTL withdrawals after releases. Moreover, the IRS should work with the National Taxpayer Advocate, in addition to Chief Counsel, with respect to this guidance, in order to ensure that the taxpayer's perspective is considered.

Finally, the National Taxpayer Advocate disagrees that current training efforts and updates are sufficient to convey IRS lien determination policy to all employees involved in NFTL filing. As stated above, the IRS responses to NFTL-related TAOs demonstrate IRS employees' lack of understanding of statutory authority.[104] It is also surprising that the IRS rejects TAS's offer of assistance in training Collection employees. The National Taxpayer Advocate believes these employees will benefit from the TAS training video, *Taxpayer Rights: Collection Case Studies*, which illustrates the NFTL process from a taxpayer's perspective.

Recommendations

The National Taxpayer Advocate recommends that the IRS take the following specific actions:

1. Immediately implement a quality review of Designated Payment Codes.
2. Adopt two long-term effectiveness measures to ensure that employees file appropriate and productive NFTLs.
    a. First, the IRS should measure the total and average revenue (dollars collected) attributable to NFTL filings.
    b. Second, it should measure the long-term impact of the NFTL on the taxpayer's compliance behavior.[105]
3. Abandon the policy of automatic NFTL filing on CNC hardship accounts with an unpaid balance of $5,000 or more.
4. Implement the provisions of RRA 98 § 3421 by basing lien filing determinations for all IRS contact employees on a thorough review of all the taxpayer's circumstances (including the existence and the value of assets, the taxpayer's financial information, and the ramifications of the lien on the taxpayer's credit rating), after an in-person

[103] Memorandum from Branch 3 (Procedure and Administration) to Special Counsel (National Taxpayer Advocate), Ref. No. POSTN-133674-09 (Oct. 8, 2009).

[104] For example, in one recent case, the TAO was returned to the LTA for reconsideration because the manager believed that to withdraw an NFTL, the taxpayer had to meet all four of the provisions under IRC § 6323(j) instead of meeting only one. The taxpayer signed a written consent allowing TAS to release this tax return information.

[105] *See* Nina E. Olson, *Minding the Gap: A Ten-Step Program for Better Tax Compliance*, 20 Stan. L. & Pol'y Rev. 7, 23 (2009).

or telephone interview with the taxpayer and substantive consideration of the facts, which may include consultation with a manager.

5. Require managerial approval for NFTL filings in all cases where the taxpayer has no assets, regardless of the employee's grade level.
6. Immediately issue interim guidance to allow, upon the request of a taxpayer, the withdrawal of an NFTL where the statutory withdrawal criteria are satisfied, even if the underlying lien has been released. After consulting with the IRS Office of Chief Counsel on the interpretation of IRC § 6323(j) and, consistent with the counsel advice, revise the IRM to provide guidance on when withdrawal of an NFTL is appropriate in cases in which the lien has already been released.
7. Conduct annual training for collection employees and managers in exercising judgment and discretion before and after NFTL filing, and include the TAS training video, *Taxpayer Rights: Collection Case Studies*, as part of the training.

MSP #3

The IRS Lacks a Servicewide Return Preparer Strategy

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DEFINITION OF PROBLEM

Return preparers are key partners in the tax system because of their essential role in facilitating the preparation of tax returns, protecting taxpayer rights, and influencing tax compliance. The IRS relies on preparers to educate taxpayers about tax laws, facilitate efficient electronic tax filing, and reduce the stress and anxiety often associated with the filing season.[1] About 58 percent of individual taxpayers and most business taxpayers pay preparers to handle their returns.[2] In light of the critical role return preparers play in tax administration, it is essential that the IRS ensure preparers are competent, visible, and accountable.

While the IRS has made significant strides in the return preparer arena, its efforts to date have fallen short in several respects. The National Taxpayer Advocate has repeatedly urged the IRS and Treasury to develop and implement a program to test, register, and certify "unenrolled" preparers.[3] Despite numerous studies finding significant noncompliance among

1 *See* National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, 74-116 (Leslie Book, *The Need to Increase Preparer Responsibility, Visibility and Competence*); National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 44-74 (Leslie Book, *Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws*).

2 IRS Compliance Data Warehouse, Individual Returns Transaction File, Tax Year 2007 (Aug. 2009).

3 *See* National Taxpayer Advocate Fiscal Year (FY) 2010 Objectives Report to Congress xiii-xv (Area of Emphasis: *TAS Will Continue to Advocate for a More Robust Return Preparer Strategy*); National Taxpayer Advocate 2008 Annual Report to Congress 423-26 (Legislative Recommendation: *The Time Has Come to Regulate Federal Tax Preparers*); National Taxpayer Advocate 2006 Annual Report to Congress 197-221 (Most Serious Problem: *Oversight of Unenrolled Return Preparers*); National Taxpayer Advocate 2005 Annual Report to Congress 223-37 (Most Serious Problem: *Regulation of Electronic Return Originators*); National Taxpayer Advocate 2004 Annual Report to Congress 67-88 (Most Serious Problem: *Oversight of Unenrolled Return Preparers*); National Taxpayer Advocate 2003 Annual Report to Congress 270-301 (Legislative Recommendation: *Federal Tax Return Preparers: Oversight and Compliance*); National Taxpayer Advocate 2002 Annual Report to Congress 216-30 (Legislative Recommendation: *Regulation of Federal Tax Return Preparers*); *see also Fraud in Income Tax Return Preparation: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 109th Cong. (2005) (statement of Nina E. Olson, National Taxpayer Advocate); *Preparing Your Taxes: How Costly Is It?: Hearing Before the S. Comm. On Finance*, 109th Congress (2006) (statement of Nina E. Olson, National Taxpayer Advocate). In her 2003 Annual Report to Congress, the National Taxpayer Advocate further encouraged Congress to enact a more stringent compliance and penalty regime to deter reckless disregard of the rules and/or negligence by paid preparers. National Taxpayer Advocate 2003 Annual Report to Congress 270-301. Based on continual discussions with internal and external stakeholders, the National Taxpayer Advocate's recommendation has evolved since originally proposed. The initial proposal was to require an entrance exam and annual refresher exams thereafter. After discussing the issue with various stakeholder groups, we believe that tax preparers, after passing an entrance exam, should be given the choice of passing periodic refresher exams or taking periodic continuing professional education courses.

return preparers, there is still virtually no federal oversight over unenrolled preparers, who constitute a substantial portion of all preparers.[4] In 2009, the IRS launched a wide-ranging review of return preparer issues with the ultimate goal of delivering recommendations to the Secretary of the Treasury and the President about how to better leverage the preparer community for the overall benefit of the tax system. It is imperative that any resulting strategy be balanced by including both service and enforcement components to ensure that preparers have all the tools they need for optimal compliance and are fully aware of the consequences of their actions.

The National Taxpayer Advocate supports this commendable effort, and our office has been included in the internal IRS working group charged with developing a return preparer strategy. This section of the Annual Report was written before the IRS finalized and submitted its recommendations and is therefore not intended as commentary on the new IRS proposals. Rather, this section describes the National Taxpayer Advocate's assessment of what a comprehensive and effective return preparer strategy should include.

ANALYSIS OF PROBLEM

Background

Use of Preparers by Individuals and Businesses

For tax year (TY) 2007, 58 percent of individual income tax filers used return preparers to meet their filing obligations, and the percentage jumped to 70 percent for those claiming the Earned Income Tax Credit (EITC).[5] Moreover, in TY 2007, 80 percent of small business filers hired return preparers.[6]

Return Preparers Play a Significant Role in the Tax System

IRS research illustrates the significant role return preparers play in tax administration. Research conducted by the Small Business/Self-Employed (SB/SE) Operating Division found taxpayers who switched from preparing their own returns to using a paid preparer in TY 2005 were more likely to:

- File electronically;
- File a more complex return than in the previous year;
- Switch to a new filing status;
- Claim the EITC; and

[4] *See* National Taxpayer Advocate 2003 Annual Report to Congress 270-301 (estimating that of the 1.2 million known tax return preparers, approximately 300,000 to 600,000 are not regulated by any licensing entity or subject to minimum competency requirements).

[5] IRS Compliance Data Warehouse, Individual Returns Transaction File, Tax Year 2007 (Aug. 2009).

[6] IRS, Pacific Consulting Group, *SB/SE Customer Base Report, Covering Tax Year 2008* (Aug. 2009), *available at* http://wsep.ds.irsnet.gov/sites/co/dcse/sbse/sf/ppm/Cust%20Sat/Shared%20Documents/Customer%20Base/Customer%20Base%20REPORTS/Customer%20Base%202008.pdf.

- File a return that falls under the jurisdiction of a different business operating division.[7]

This research does not directly link preparers to taxpayer behavior. It is plausible that the taxpayers who switched did so because of an underlying change in their circumstances. Nonetheless, while this research does not prove that preparers caused taxpayers to change their filing behavior, it suggests that taxpayer filing patterns may be heavily influenced by the use of a preparer.

In FY 2007, the Taxpayer Advocate Service commissioned Professor Leslie Book to conduct a two-part study on the role of return preparers in taxpayer compliance. The first report, published in Volume 2 of the 2007 Annual Report, addressed the role of practitioners in taxpayer decisions to comply with the tax laws, with a focus on sole proprietors and taxpayers claiming EITC. The report noted the significant usage of preparers and the high error rate among those returns.[8] The second part of the study, which was published in Volume 2 of the 2008 Annual Report, proposes legislative and administrative steps that the IRS can take to increase preparer compliance with unambiguous tax law issues. The common themes of the proposals are increasing preparer competence, visibility, and accountability.[9]

In addition, the following organizations have conducted research through "shopping visits" to preparers and have uncovered significant noncompliance:

- **Government Accountability Office (GAO).**[10] In 2006, GAO auditors posing as taxpayers made 19 visits to several national tax preparation chains in a large metropolitan area. Using two carefully designed fact patterns, they sought assistance in preparing tax returns. Among the results:
  - The tax preparation chains made errors on all 19 returns.
  - In 17 instances, the preparers computed the wrong refund amounts, with variations of several thousand dollars. In five cases, the prepared returns reflected unwarranted excess refunds of nearly $2,000, and in two cases, the prepared returns would have caused the taxpayer to overpay by more than $1,500.
  - Preparers failed to ask where the auditor's child lived or ignored the auditor's answer to the question in five of ten applicable cases, and consequently prepared returns claiming ineligible children for purposes of the EITC.
  - In ten out of 19 cases, preparers failed to report cash side income. Several preparers even advised the GAO "taxpayers" that reporting certain income was unnecessary because the IRS would have no way of knowing about it.

7 SB/SE Research, Project STP0095, *Differences in Return Characteristics When Taxpayers Switch from Self-Preparing to Using a Paid Preparer* (Nov. 2008).

8 National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 44-74 (Leslie Book, *Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws*).

9 *Id.* at 74-116.

10 Government Accountability Office, GAO-06-563T, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors* 2 (Apr. 4, 2006) (statement of Michael Brostek, Director - Strategic Issues, Before the Committee on Finance, U.S. Senate).

- In ten cases, shoppers were entitled to a credit for child care expenses, yet no preparer claimed the credit.
- In two out of nine cases, preparers claimed the standard deduction where itemizing deductions would have been more advantageous.
- In four out of 19 cases, the preparer did not sign the return.

- **Treasury Inspector General for Tax Administration (TIGTA).**[11] In 2008, TIGTA auditors posing as taxpayers visited 12 commercial chains and 16 small, independently owned tax return preparation offices in a large metropolitan area. All of the preparers visited by TIGTA were unlicensed and unenrolled. Among the results:
  - Of the 28 returns prepared, 61 percent were prepared incorrectly.
  - If the incorrect tax returns had been filed, the net effect would have been $12,828 in understated taxes, or an average net understatement per return of $755.
  - None of the seven preparers working with fact patterns involving EITC claims exercised appropriate due diligence.
  - Sixty-five percent of the inaccurate returns contained mistakes or omissions deemed to be caused by human error and/or misinterpretation of the tax laws.
  - Thirty-five percent of the inaccurate returns contained misstatements or omissions that TIGTA deemed willful or reckless.
  - All of the business returns were prepared inaccurately.
  - In five out of 28 cases, the preparer did not sign the return.

- **New York State Department of Taxation and Finance.**[12] Over a recent 20-month period, agents conducted nearly 200 targeted covert visits in which they posed as taxpayers and sought assistance in preparing income or sales tax returns. In testimony at an IRS Public Forum, the Acting Commissioner of the New York Department of Taxation and Finance testified that investigators found "an epidemic of unethical and criminal behavior." At one point, the Department reported that it had found fraud on about 40 percent of its visits.[13] To date, the Department has made more than 20 arrests and has secured 13 convictions. The Acting Commissioner testified that the investigation is continuing and more arrests are expected.
- **Impact Alabama.** In January 2009, an Alabama nonprofit agency sent 13 volunteers to Alabama tax preparation services, including both small seasonal firms and large national operations. All of the 13 returns prepared contained errors. Most of the mis-

11 TIGTA, Ref. No. 2008-40-171, *Most Tax Returns Prepared by a Limited Sample of Unenrolled Preparers Contained Significant Errors* (Sept. 3, 2008).

12 Statement of Jamie Woodward, Acting Commissioner, New York Dept. of Taxation and Finance, before IRS Tax Return Preparer Review Public Forum (Sept. 2, 2009), *available at* http://ftp.irs.gov/pub/irs-utl/ny_department_of_tax_statement.pdf (lasted visited Oct. 18, 2009).

13 *See* Tom Herman, *New York Sting Nabs Tax Preparers*, Wall Street Journal (Nov. 26, 2008).

takes involved the right to claim EITC by divorced parents sharing custody of children, a very complex and fact-specific legal inquiry.[14]

- **Community Legal Services of Philadelphia and Community Reinvestment Association of North Carolina.** These two groups conducted visits to study preparers marketing refund anticipation loans (RALs). However, the summary of the report findings noted "[o]ne of the most disturbing test results involved the quality of tax preparation. Several of the preparers made serious errors that significantly affected tax liability."[15]
- **New York City Department of Consumer Affairs.** In January 2009, New York City Department of Consumer Affairs (DCA) inspectors examined more than 430 tax preparation businesses and issued more than 1,200 notices of violations to 150 businesses. Top violations included deceptively advertising RALs. Fines imposed could reach as high as $600,000. This year, DCA increased its inspections of income tax preparers by 43 percent, targeting businesses charged with violations in 2008 as well as neighborhoods with high concentrations of EITC claims. Together, the compliance visits and penalties increased compliance rates from 56 percent to 65 percent. [16]

Despite evidence indicating a correlation between return preparers and taxpayer noncompliance, the IRS has yet to conduct strategic research to determine the various types of preparer noncompliance or the reasons and appropriate treatment for each type of noncompliance.[17]

IRS Focus on Return Preparers: Development of Servicewide Strategy

The IRS has increasingly acknowledged the critical role preparers play in the tax system. The IRS Strategic Plan for 2009-2013 states as an objective: "Ensure that all tax practitioners, tax preparers and other third parties in the tax system adhere to professional standards and follow the law."[18] During FY 2008 and 2009, the IRS also committed to increase return preparer compliance by developing a comprehensive Servicewide Return Preparer Strategy. This initiative, which TAS participated in, was disbanded in 2009 in anticipation of a new high-level review of the IRS's return preparer initiatives.

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14 Russell Hubbard, *Tax Preparers Cheating Customers, Government, Alabama Nonprofit Finds*, Birmingham News (Jan. 23, 2009).

15 National Community Law Center, *Tax Preparers Take a Bite out of Refunds: Mystery Shopper Test Exposes Refund Anticipation Loan Abuses in Durham and Philadelphia* (Apr. 2008).

16 New York City Department of Consumer Affairs, Press Release, *NYC Department of Consumer Affairs Announces Citywide Enforcement Sweep of Income Tax Preparers* (Feb. 5, 2009).

17 *See* Karen Masken, Mark Mazur, Joanne Meikle & Roy Nord, IRS Office of Research, Analysis, and Statistics, *Do Products Offering Expedited Refunds Increase Income Tax Non-Compliance?* 15 ("While our analysis indicates that noncompliance is higher among taxpayers using RALs, we cannot conclude that the availability or utilization of RALs causes noncompliance.")

18 IRS, *Strategic Plan 2009-2013, Goal 2, Objective 6*. The strategies to achieve the stated goal include:

- Develop and implement a coordinated preparer plan across the IRS and the preparer community;
- Administer a fair, diligent, and effective system of sanctions and penalties for those who fail to follow the law; and
- Leverage research to identify fraudulent return preparers and other areas of abuse and noncompliance by return preparers.

In June 2009, the IRS announced a comprehensive review of its approach toward return preparers, including the tax return preparation and tax software industry, with a goal of developing recommendations to "better leverage the tax return preparer community in increasing taxpayer compliance and ensuring high ethical standards of conduct for paid tax preparers."[19] TAS actively participated on the review team.

Continuing Need for Servicewide Return Preparer Strategy

The National Taxpayer Advocate commends the IRS for its considerable strides in focusing on return preparer issues. TAS looks forward to continued participation on the team to finalize and implement any resulting recommendations. However, in the interim, we would like to set forth what we believe should be the crucial components of any servicewide return preparer strategy:

- *Ensure Competence.* The strategy should ensure that preparers are competent. To accomplish this goal, the IRS should require unenrolled tax preparers to pass an examination and thereafter to complete periodic continuing professional education (CPE) requirements in connection with a national system to register, test, and certify unenrolled preparers. Equally important, the IRS should provide services, education, and outreach to equip preparers with the tools they need to prepare accurate returns.
- *Increase Visibility.* To adequately oversee preparers, the IRS must improve its ability to track them. This involves requiring all individual preparers to obtain unique identifying numbers as well as conducting a public awareness campaign to inform the taxpaying public about any new preparer requirements.
- *Increase Preparer Accountability.* Preparers should know that their actions have consequences. The IRS should focus additional resources on preparer compliance initiatives. To do so effectively, the IRS should more thoroughly study the causes of preparer noncompliance and the best ways to change this behavior. For example, mystery shopping visits would help the IRS to better grasp the scope and nature of preparer noncompliance as well as deter preparer noncompliance. Cognitive learning initiatives could provide useful information on which to base future preparer education and compliance initiatives. Once the IRS has a better understanding of preparer behaviors and their influence on taxpayer compliance, it can develop a more effective enforcement strategy. The National Taxpayer Advocate believes such a strategy should include increased penalties, soft notices, progressive enforcement techniques, and a streamlined complaint reporting process.

Ensuring Preparer Competence

The IRS can increase preparer competence by supporting minimum entrance requirements for the profession and providing targeted education, outreach, and services to enable

[19] Tax Notes Today, *IRS to Make Recommendations on Regulating Tax Return Preparers by Year's End* (June 5, 2009).

preparers to understand their responsibilities and properly educate and assist taxpayers. Research supports the need to reach preparers early to prevent attitudes of habitual noncompliance from developing. Thus, by dedicating resources to preparer competence early on, the IRS is likely to save significant compliance resources downstream.[20] The IRS provides a wealth of services to preparers, both before and following each tax filing season. However, the services are not part of a consistent, research-driven, servicewide plan, and the IRS does not measure the impact these services have on taxpayer and preparer compliance.[21]

National System to Register, Test, and Certify Preparers

Since 2002, the National Taxpayer Advocate has proposed a plan for the IRS to register, test, and certify unenrolled preparers.[22] Given the role that preparers play in guiding taxpayers through our complex tax laws, it is incumbent on the IRS to register and identify unenrolled preparers and administer a basic examination to ensure at least a minimal level of competency. Requiring preparers to register in a formal program and meet strict requirements could set the stage for preparers to take their preparation and filing responsibilities more seriously.[23] Although the GAO, TIGTA, and other studies cited above are not statistically representative of the full population of prepared returns, they suggest that a sizeable segment of the preparer population prepares inaccurate returns, fails to perform adequate due diligence, and even takes positions that the preparers know are not correct (*e.g.,* encouraging taxpayers to omit items of gross income from their returns or, in some cases, claiming ineligible children for purposes of the EITC). This conduct usually results in understatements of tax (reducing federal tax revenue and potentially subjecting taxpayers to enforcement actions) and sometimes results in overstatements of tax (causing taxpayers to pay more than they owe). Higher competency and ethics standards are therefore necessary both to provide better consumer protection and to improve compliance.

The National Taxpayer Advocate believes examinations should be administered in two tiers: (1) the first tier would address issues that arise on basic 1040 returns and include Schedules C-EZ and (2) the second tier would cover more complex 1040 returns as well as business returns.[24] It is important that the second-level test include business returns beyond the Form 1040 series, as IRS has found significant compliance problems on

20 National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, 77 (Leslie Book, *The Need to Increase Preparer Responsibility, Visibility, and Competence*).

21 *See* IRS, *Return Preparer Strategy: Understanding and Partnering with the Return Preparer Community to Improve Voluntary Tax Compliance* 7-10 (Mar. 31, 2008).

22 *See* note 3, *supra*.

23 National Taxpayer Advocate 2008 Annual Report to Congress, vol. 2, 92 (Leslie Book, *The Need to Increase Preparer Responsibility, Visibility and Competence*).

24 While not statistically representative, the shopping visits recently conducted by TIGTA support the importance of instituting an exam for business returns immediately. All of the business returns were prepared inaccurately in the TIGTA audit, which indicates that business return preparation is a significant and immediate problem. TIGTA, Ref. No. 2008-40-171, *Most Tax Returns Prepared by a Limited Sample of Unenrolled Preparers Contained Significant Errors* (Sept. 3, 2008).

S corporation and other business returns as well.[25] Moreover, an ongoing CPE requirement, including an ethics component, would keep preparers current on tax law changes and reinforce difficult concepts that are subject to high rates of error. As discussed below, a public information campaign to educate taxpayers about how to find an appropriate preparer should be an integral part of any system of regulation.

The National Taxpayer Advocate believes that to be effective, registration and testing requirements should apply to any preparer who interacts with a taxpayer and prepares the taxpayer's return. For some purposes, current Treasury regulations distinguish between a preparer who signs a tax return (a "signing tax return preparer") and a preparer who prepares all or a substantial portion of a return but does not sign it (a "nonsigning tax return preparer").[26] In some tax return preparation businesses, multiple preparers meet with taxpayers and prepare their returns, yet a single individual signs all returns. Thus, if the IRS were to regulate solely "signing tax return preparers," many individuals engaged in return preparation would not be subject to the registration, testing, and CPE requirements and the effectiveness of the regulation regime could be substantially undercut. Moreover, an incentive would arise for return preparation businesses to rely more heavily on nonsigning preparers to avoid the costs and burden associated with the registration, testing, and CPE requirements.[27]

It is important to note that the National Taxpayer Advocate believes the IRS should require every preparer to register and obtain a single identification number. However, practitioners covered by Circular 230, which governs "practice" before the IRS,[28] should be exempt from the examination and CPE requirements. These practitioners already face education, examination, and in most cases CPE requirements, while ethical rules prevent them from accepting assignments for which they are not competent.[29]

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25 Based on IRS research, approximately 68 percent of S corporation returns filed for tax year 2004 misreported net corporation income. This amounts to underreported income of approximately $56 billion. Furthermore, approximately 93 percent of S corporation returns were prepared by paid preparers. IRS Research, Analysis, and Statistics, 2009 IRS Research Conference, *Preliminary Results of the 2003/2004 National Research Program S Corporation Underreporting Study*, Slide 9 (July 2009); SB/SE Research, *FY 06 Nationwide Analysis: Electronic Tax Administration Business Master File Marketing Database*, Project BKN0045, Slide 39 (May 2006).

26 *See* Treas. Reg. 301.7701-15(b).

27 The National Taxpayer Advocate believes that such registration requirements should apply to all preparers who have direct substantive interaction with taxpayers (*e.g.*, face-to-face or telephonic meetings) and should not be limited only to the individual who signs the return. More specifically, the registration requirements should apply to individuals who perform the interviewing and return preparation functions but not to individuals who perform solely clerical or ministerial work.

28 31 C.F.R. part 10. Circular 230 governs the conduct of return preparers who practice before the IRS. Typically, in order to practice before the IRS, a practitioner needs to be an attorney, certified public accountant, enrolled agent, or enrolled actuary. However, the regulation also allows for limited practice before the IRS for return preparers who do not fit into one of the aforementioned categories. Circular 230, 31 C.F.R. Part 10, §§ 10.3, 10.7. Section 10.2(a)(4) of Circular 230 defines practice before the IRS as:

> [C]omprehending all matter connected with a presentation to the Internal Revenue Service or any of its officers or employees relating to a client's rights, privileges or liabilities under laws or regulations administered by the Internal Revenue Service. Such presentations include preparing and filing necessary documents, corresponding and communicating with the IRS, and representing a client at conferences, hearings and meetings.

29 In addition, 5 U.S.C §§ 500(b) & (c) grant attorneys and CPAs the authority to represent clients before federal agencies (upon submitting a written declaration stating qualifications). Thus, absent a statutory change, the IRS cannot require these practitioners to pass a test or complete continuing education before they are able to prepare returns.

The National Taxpayer Advocate's proposal has received widespread support from stakeholders and members of Congress.[30] The Senate Finance Committee has twice approved legislation to regulate federal income tax preparers,[31] with the full Senate also approving the legislation once.[32] In 2005, the House Ways and Means Subcommittee on Oversight held a hearing at which representatives of five outside organizations testified in support of regulating return preparers.[33] More recently, proposals to regulate return preparers were included in two separate bills during the 110th Congress – S.1219, the Taxpayer Protection and Assistance Act of 2007, and H.R. 5716, the Taxpayer Bill of Rights Act of 2008.[34] Both included provisions to equip preparers with the knowledge and skills to prepare accurate returns.

In addition, several states have experience in regulating return preparers. Oregon and California have established requirements that preparers must meet before preparing tax returns in those states. Maryland recently enacted legislation to regulate paid preparers, effective June 2010.[35] New York State recently enacted legislation requiring the registration of return preparers.[36]

California's return preparer program requires qualifying education and the completion of continuing education. Oregon has a two-tiered licensing program with the first tier requiring qualifying education, an examination, and continuing education, and the second tier requiring work experience and a second examination. The GAO evaluated both programs and determined the one in Oregon seemed to increase the accuracy of returns prepared in that state as compared to the rest of the country, whereas returns filed in California were *less* likely to be accurate than elsewhere in the country. While GAO was unable to draw firm conclusions due to the role of other factors, its findings lend support for requiring preparers to pass an initial examination in addition to taking continuing education.[37]

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30 GAO, GAO-08-781, *Oregon's Regulatory Regime May Lead to Improved Federal Tax Return Accuracy and Provides a Possible Model for National Regulation* (Aug. 15, 2008).

31 H.R. 1528 (incorporating S. 882) (108th Cong.); S. 1321 (incorporating S. 832) (109th Cong.).

32 H.R. 1528 (incorporating S. 882) (108th Cong.).

33 The organizations were the American Bar Association, the American Institute of Certified Public Accountants, the National Association of Enrolled Agents, the National Society of Accountants, and the National Association of Tax Professionals. *See Fraud in Income Tax Return Preparation: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways & Means*, 109th Cong. (July 30, 2005).

34 S. 1219, § 4, 110th Cong. (2007); H.R. 5716, § 4, 110th Cong. (2008).

35 The Maryland Individual Tax Preparers Act establishes an eight-person Board of Income Tax Preparers and, effective June 2010, requires all preparers not specifically exempted to register, pay a fee, and take an examination modeled after the Special Enrollment Examination prepared by the IRS. The preparer must renew the registration every two years, at which time the preparer must pay a renewal fee and provide evidence of completion of continuing education requirements. Maryland Individual Tax Preparers Act, Senate Bill 817, Md. Code Business Regulation and Occupations, chap. 623 (May 22, 2008).

36 N.Y. Tax Law § 32. *See* N.Y. Dept. of Taxation and Finance, Office of Tax Policy Analysis, Taxpayer Guidance Division, Tax Preparer Registration Program, TSB-M-09(11)C, (9)I, (10)M, (3)MCTMT, (4)R, (15)S (Oct. 1, 2009), *available at* http://www.tax.state.ny.us/pdf/memos/multitax/m09_11c_9i_10m_3mctmt_4r_15s.pdf (last visited Oct. 18, 2009), Tax Preparer Registration Program; Statement of Jamie Woodward, Acting Commissioner, New York State Dept. of Taxation and Finance, IRS Tax Return Preparer Review Public Forum (Sept. 2, 2009), *available at* http://ftp.irs.gov/pub/irs-utl/ny_department_of_tax_statement.pdf (last visited Oct. 18, 2009).

37 GAO, GAO-08-781, *Oregon's Regulatory Regime May Lead to Improved Federal Tax Return Accuracy and Provides a Possible Model for National Regulation* (Aug. 15, 2008). *See* transcripts and submitted statements from the IRS Tax Return Preparer Review Public Forum (Sept. 2, 2009), *available at* http://ftp.irs.gov/taxpros/article/0,,id=212450,00.html.

A small number of stakeholders have expressed concern that competency exams could have the effect of excluding some preparers who would otherwise be preparing tax returns. We acknowledge that some level of exclusion is an inherent consequence of any examination requirement. High school students generally must pass certain examinations to graduate, motorists generally must pass an exam to obtain a license, and doctors, lawyers, and actuaries (among many others) must pass examinations to practice their professions. All of these tests are exclusionary, but are required because policymakers have decided that ensuring competence is a priority. In our view, the appropriate focus here should be on the level of difficulty of the test. The National Taxpayer Advocate believes the bar should be set high enough to ensure basic competency but not so high as to require unreasonable levels of knowledge and put large numbers of competent preparers out of business.

Governance of the Program

If the IRS decides to implement a system to regulate preparers, the next logical step is to determine the governance and infrastructure of the program. In light of the impact preparer practices have on every function in the IRS, it is important that an executive steering committee and a program office, both under the Deputy Commissioner (Services and Enforcement), assume responsibility for development of policies and procedures as well as continual monitoring duties regarding administration and technical interpretation of the tax provisions under Title 26. Thus, the cross-functional steering committee and program office would have oversight responsibility for Title 26 initiatives and programs, including but not limited to: (1) preparer penalties; (2) preparer audits; (3) a responsive regulation approach to enforcement; (4) shopping visits; (5) due diligence initiatives; and (6) outreach, education, and public awareness campaigns. TAS and the Office of Professional Responsibility (OPR) should have representation on the cross-functional steering committee along with affected business functions under the jurisdiction of the Deputy Commissioner (Operations Support). Ethical standards and standards of practice should continue to be handled by OPR. Thus, OPR would have oversight responsibility for registration, testing, CPE, and Circular 230 sanctions as it already does for enrolled agents (EAs).

Shortly after the IRS announced its return preparer review, it issued a Request for Proposal (RFP) for assistance in studying and standing up a self-regulating organization (SRO) to implement, maintain, and enforce a new regulatory regime. Examples of existing SROs include the Public Company Accounting Oversight Board (PCAOB) and the Financial Industry Regulatory Authority (FINRA).[38] The IRS quickly announced that the RFP had been issued in error and withdrew it. In the event the approach receives further consideration, however, we note several concerns about this potential type of oversight model. First, the IRS would face disclosure challenges if it uses an SRO model that do not exist in other industries, because enforcement actions would necessarily require access to confidential tax return information that the IRS generally may not disclose to outside parties. The IRS is

[38] *See* Jeremiah Coder, *News Analysis: Will Self-Regulation of Preparers Take Root?* Tax Notes (July 6, 2009).

appropriately subject to restrictive disclosure rules in Internal Revenue Code (IRC) § 6103 to protect confidential taxpayer information, and we have significant concerns about loosening those restrictions. Second, the SRO model may not lend itself to this profession, given the broad spectrum of individuals who prepare returns. On one end are those who are completely untrained in tax law but provide tax preparation to lure customers in the door to buy their main products and services. At the other end are highly trained and dedicated preparers. An SRO may have difficulty overseeing such a wide variety of preparers with different motivations. Finally, the IRS does not use an SRO model to oversee enrolled agents, and there appears to be no persuasive reason to treat the two types of preparers differently.

To date, one obstacle to implementing a registration program has been concerns about cost. The IRS should consider charging user fees to defray the costs of administering the program, as the states that regulate preparers already do and the IRS currently does with the Enrolled Agent program. Moreover, without going as far as the SRO model, the IRS could contract with a third-party vendor to assist in administering the registration or testing process (while retaining enforcement responsibility within the IRS). Third parties experienced in running similar but smaller scale programs have proven that the program could be self-funded through registration fees.[39]

Enhancing Preparer Visibility

The first step for the IRS toward preparer oversight and a meaningful partnership with preparers is the ability to track preparers. The IRS Office of Professional Responsibility currently tracks only enrolled agents, enrolled retirement plan agents, and enrolled actuaries. The existing oversight model renders the IRS unable to accurately quantify the total number of preparers. The IRS estimates that between 800,000 and 1.2 million preparers submitted returns in TY 2006.[40] As the IRS has trouble merely estimating the total number of preparers, it cannot provide effective services to this population or identify problematic preparers and apply compliance treatments.[41]

Preparer Tax Identification Number Regulation Project

When a preparer prepares and signs a tax return, he or she must provide an identifying number.[42] Currently, preparers provide a Social Security number (SSN), Preparer Tax Identification Number (PTIN), or Employer Identification Number (EIN), if anything at all, on returns submitted to the IRS. The lack of consistency makes it difficult for the IRS to identify, quantify, and track preparers.

39 *See* transcript and statements from Sept. 2, 2009 IRS Tax Return Preparer Review Public Forum, *available at* http://ftp.irs.gov/taxpros/article/0,,id=212450,00.html (last visited Oct. 18, 2009). Both the California and Oregon programs were described as self-funded through registration fees.

40 IRS, *Return Preparer Strategy: Understanding and Partnering with the Return Preparer Community to Improve Voluntary Compliance* 3 (Mar. 31, 2008).

41 TIGTA, Ref. No. 2009-40-098, *Inadequate Data on Paid Preparers Impedes Effective Oversight* (July 14, 2009).

42 IRC § 6109.

The National Taxpayer Advocate asked the IRS and the Treasury Department to include a project on the 2008-2009 Priority Guidance Plan to revise the regulations under IRC § 6109, and it is our understanding that the project at this writing is still in progress.[43] We believe the regulation should be revised to eliminate the option under the existing regulation to use the individual preparer's SSN as an identifying number. In all cases, preparers should be required to provide a PTIN and, if applicable, an EIN as well.

The IRS would benefit greatly from an improved ability to track preparers through the use of a single identifying number. If implemented properly, a PTIN requirement would also enable the IRS to track preparers by type (attorney, CPA, enrolled agent, or unenrolled preparer). With comprehensive data about the preparer population, the IRS could better identify trends and problem preparers. In addition, the IRS could target outreach and education more effectively if it could sufficiently identify high error rates among certain categories of preparers with respect to certain issues.

To maximize the usefulness of PTINs, the IRS should systematically validate the identifying numbers on the returns (*i.e.*, where a preparer enters a number, the IRS should cross-check the preparer's TIN to determine its validity). Absent a validation process, a PTIN requirement would be difficult to enforce and would add limited value.

We note that eliminating the use of a preparer's SSN on tax returns would also benefit return preparers by reducing their susceptibility to identity theft.

Need for Continued Public Awareness Campaign

The National Taxpayer Advocate believes that, in conjunction with a system to register return preparers, the IRS should conduct a public awareness campaign over several years. Initially, the campaign should inform taxpayers of the significance of the return preparer's signature, PTIN, or registration requirements, as applicable. By delivering a strong public information campaign, the IRS would engage taxpayers in the enforcement of the preparer requirements.[44] As taxpayers become more accustomed to these messages and more knowledgeable about the IRS "brand," the IRS should consider changing its message and modifying penalty assessment procedures so taxpayers do not qualify for the reasonable cause exception for assessed penalties by reason of using a preparer who fails to meet signature, PTIN, or registration requirements, as applicable.[45]

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43 The project to revise the regulations under IRC § 6109 has also been included on the 2009-2010 Priority Guidance Plan. *See* http://www.irs.gov/pub/irs-utl/2009_-_2010_priority_guidance_plan.pdf.

44 IRC § 6695(b).

45 The IRS waives the penalties under IRC §§ 6651 (Failure to File and Failure to Pay penalties) and 6662 (Imposition of Accuracy Related Penalty on Underpayments) if the taxpayer can establish reasonable cause.

Need to Increase Preparer Accountability

The third vital component of an effective return preparer program is holding preparers accountable for their actions. The IRS has many preparer enforcement initiatives,[46] the cornerstone of which is the assessment and collection of preparer penalties. However, it is clear that the IRS has a long way to go in developing a research-driven, servicewide, and effective return preparer strategy for enforcement.

Including Ethical Duties of Return Preparation in Circular 230

Attorneys, CPAs, enrolled agents, enrolled retirement plan agents, enrolled actuaries, and appraisers are subject to the requirements of Circular 230, which governs "practice" before the IRS. The regulations provide duties and restrictions to which practitioners must adhere in order to practice before the IRS. Preparation of a tax return is not currently considered practice before the IRS. In light of the impact of tax return preparation on the tax system, however, we believe it is in the best interests of taxpayers and tax administration to add a section that provides ethical duties, restrictions, best practices, and sanctions specific to preparers.

Researching Types and Causes of Preparer Noncompliance

Before the IRS can effectively discourage preparer noncompliance, it needs to understand what factors drive their noncompliance. For this purpose, research suggests that preparers can be grouped into three categories:

1. Type 1: The honest and risk-averse preparer;
2. Type 2: The cautious preparer who aims to minimize tax; and
3. Type 3: The preparer who is a creative and aggressive tax planner (which presumably includes preparers who cross the line).[47]

Each type of preparer has different motives and reasons for noncompliance. As such, the IRS should apply different treatments to each distinct type of preparer. It would also be useful to see how each type of preparer behaves when paired up with taxpayers who fit into each of the three above-discussed categories. This type of research lends itself well to a cognitive learning lab.[48]

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46 For a discussion of the various enforcement initiatives, see IRS, *Return Preparer Strategy: Understanding and Partnering with the Return Preparer Community to Improve Voluntary Tax Compliance* 19-20 (Mar. 31, 2008).

47 National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 59 (Leslie Book, *Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws*); Yuka Sakurai & Valerie Braithwaite, *Taxpayer's Perceptions of the Ideal Tax Adviser: Playing Safe or Saving Dollars?*, Centre for Tax System Integrity, Working Paper No. 5 (May 2001), *available at* http://ctsi.anu.edu.au/publications/WP/5.pdf.

48 For a discussion of the various factors affecting the moral reasoning of tax practitioners, see Elaine Doyle, Jane Frecknall Hughes & Barbara Summers, *Cognitive Reasoning of Tax Practitioners: A Preliminary Investigation Using a Tax Specific Version of the Defining Issues Test* (*DIT*, (paper submitted for the 2009 IRS Research Conference, associated slides presented at the 2009 IRS Research Conference *available at* http://www.irs.gov/pub/irs-soi/09rescontaxprep.pdf (last visited Sept. 4, 2009)) and Most Serious Problem: *The IRS Needs an In-House Cognitive Research Lab to Understand Taxpayer Behavior and Test Products and Programs, infra*.

Assessment and Collection of Preparer Penalties

The following table summarizes enforcement of IRC §§ 6694 and 6695 preparer penalties between FY 2007 and FY 2009:

TABLE 1.3.1, Assessment and Collection of IRC §§ 6694 and 6695 Preparer Penalties[49]

Fiscal Year	Net Assessment	Net Collectible March 2009	% Collectible of Net Assessment	Penalties Collected	% of Net Collectible Actually Collected
2007	$2,527,625.00	$1,687,713	66.77%	$771,363	45.70%
2008	$3,235,317.00	$2,645,434	81.77%	$634,686	23.99%
2009	$2,409,085.00	$2,389,568	99.19%	$531,340	22.24%

Based on the information contained in the table, it appears that the collection of penalties remains low and leaves room for improvement. By failing to sufficiently assess and collect preparer penalties, the IRS is underutilizing one of the most effective tools available to discourage noncompliance. Assessments without collection, absent currently not collectible (CNC) determinations or other special circumstances, are assessments without teeth, and they send the wrong message. Moreover, potentially unscrupulous preparers undoubtedly notice the IRS's failure to assess and collect penalties and base their behavior on their assessment of the risk.[50]

Many preparers are also governed by Publication 1345, *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns*, the requirements of which are developed by the IRS's Office of Electronic Tax Administration and Refundable Credits and enforced through the e-file monitoring program in SB/SE. The program typically conducts annual enforcement visits to approximately one percent of the preparers subject to this regime. In 2008, the number of visits increased significantly and the number of sanctions imposed almost doubled.[51] Despite these inroads, GAO recently found that the IRS does not monitor compliance with established security and privacy standards.[52]

Addressing Preparer Errors

Effective oversight requires monitoring areas of substantial preparer noncompliance and researching and addressing the reasons behind errors. In addition to flagging errors through normal return screening, the IRS should institute so-called "mystery shopper"

49 "Net assessment" is the amount of penalties assessed minus the amount of penalties abated. "Net collectible" is the amount of net penalties assessed minus the amount deemed "currently not collectible." IRS, Enforcement Revenue Information System (ERIS) (Sept. 2009).

50 The National Taxpayer Advocate has made several legislative recommendations to increase IRC § 6695 preparer penalties as well as to impose more EITC due diligence responsibilities on preparers. These proposals included recommendations to impose a tiered penalty structure for IRC § 6695(g) penalties as well as a 100 percent penalty, similar to the Trust Fund Recovery Penalty (TFRP), against preparers who, by reason of willful and intentional misstatement, misrepresentation, fraud or deceit, prepare a return that causes a taxpayer a tax liability attributable to the EITC. National Taxpayer Advocate 2003 Annual Report to Congress 270-301.

51 IRS response to TAS research request (Aug. 25, 2008). In 2006, SB/SE conducted 1,129 visits and imposed 391 sanctions; in 2007 there were 1,299 visitations and 339 sanctions; and in 2008 there were 1,495 visits with 654 sanctions.

52 GAO, GAO-09-297, *Many Taxpayers Rely on Tax Software and IRS Needs to Assess Associated Risks* (Feb. 2009).

visits, both to learn more about challenges in the return preparation industry and to improve compliance.[53] Notably, the IRS already has experience performing shopper visits to gauge the quality of return preparation in the Volunteer Income Tax Assistance (VITA) program.[54]

Once the IRS determines an appropriate methodology and factual scenarios, local IRS employees in the Stakeholder Partnerships, Education and Communication (SPEC) organization of the W&I division and employees in the Stakeholder Liaison organization in SB/SE could perform standardized shopping visits in their communities. If a shopper observes a preparer making a certain error, the IRS could later contact the preparer to point out the mistake and educate the preparer about how to avoid the same error in the future. The IRS could then monitor that preparer, and if he or she continues to make the same error, the IRS could ramp up its efforts by transferring the case to its compliance functions.[55] If the IRS shopper were to see examples of recklessness or outright fraud during a shopping visit, it could similarly make appropriate referrals to SB/SE or the Criminal Investigation (CI) function.

Shopping visits would have both specific and general deterrence effects. Not only would a visit affect the behavior of the visited preparer, but compliance among other preparers will likely increase as word of IRS's shopping visits spreads. A preparer will be much less likely to offer to omit an item of gross income where no Form 1099 was issued or claim an ineligible child for purposes of the EITC if the preparer believes that the "taxpayer" sitting before him may be an IRS agent. The deterrent effect of taxpayer audits only operates if the IRS conducts enough of them – it conducted 1.4 million examinations in FY 2008[56] - and the deterrent effect of preparer shopping visits similarly will only work if the IRS conducts enough of them so that preparers reasonably believe they may be visited. For example, conducting 50 shopping visits a year (an average of one per state) is likely to have virtually no deterrent impact. We believe the number of visits should be in the range

53 For suggested characteristics of mystery shopper tests, see National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, 97 (Leslie Book, *The Need to Increase Preparer Responsibility, Visibility and Competence*).

54 SPEC Fact Sheet, *Understanding the Review Process* (Mar. 2008); SPEC response to TAS information request (Sept. 10, 2009) (SPEC has decided to discontinue its shopping-visits initiative at the end of FY 2009 due to limited resources).

55 Under the EITC Due Diligence Program, the IRS conducts due diligence visits where examiners are required to consider and apply the full suite of EITC penalties and sanctions, including e-file suspensions and return preparer penalties, if appropriate. In addition, these visits can serve as a means of detecting fraudulent activities that would result in fraud referrals and non-compliance that would result in recommendations for Return Preparer Program Action Cases (PACs). In 2000 and 2001, the IRS reached approximately 10,000 preparers through the EITC Preparer Outreach program. This program focused primarily on preparer outreach visits designed to educate preparers about the due diligence requirements with a small number of compliance visits. Despite these efforts, IRS did not see a decrease in the percentage of EITC overclaims. For FY 2004, the IRS had a two-part compliance strategy for the EITC Due Diligence Program, which included due diligence audits of 180 preparers and follow-up visits to those preparers who were assessed penalties to determine whether the due diligence visits changed the preparer's behavior. Due to problems with field resources and many inconsistencies, the IRS rendered the analysis of the program meaningless. IRS, Memorandum for Examination Executives, *2008 EITC Due Diligence Program Visitations* (Oct. 11, 2007); IRS, *FY 2008 EITC Due Diligence Training*. Thus, in conducting any future secret shopper or due diligence initiatives, the IRS must ensure it has rigorous strategy implementation and evaluation controls in place. Results from an evaluation of 2006 due diligence visits showed a return on investment (revenue protected to cost ratio of 39:1, which is seven times greater than the SB/SE EITC audits and produced a higher preparer penalty rate than EITC Program Action Cases). Finally, in FY 2009, SB/SE conducted 509 due diligence visits, which resulted in penalties in 53.4 percent (or 272) of the cases. In addition, W&I Research plans to analyze the change in behavior after the visits. IRS response to TAS research request (Oct. 2, 2009).

56 IRS, *Fiscal Year 2008 Enforcement Results*.

of 2,000 to 3,000 per year to start. The IRS should develop a research methodology to assess the results of the shopping visits both to measure the revenue impact of preparer-facilitated noncompliance and to evaluate the effectiveness of shopping visits at deterring noncompliance.

In the past, the IRS has expressed concerns about the costs of shopping visits. However, we believe the costs should be limited and the potential compliance gains could be significant. On the cost side, it is possible that six full-time equivalents (FTE) could conduct almost 3,000 shopping visits.[57] On the revenue side, the GAO, TIGTA and other studies showed consistently high levels of reckless and fraudulent errors that are likely costing the government tens of billions of dollars a year. For this reason, we believe that the return on investment (ROI) could substantially exceed the average ROI the IRS achieves on its enforcement spending.

Another step that should be taken to improve compliance is to impose additional due diligence requirements in areas of significant noncompliance. Currently, the EITC due diligence rules are limited by the difficulty of attributing knowledge to the preparer.[58] The same concept applies to other areas of substantial noncompliance. Thus, preparers should be required to ask taxpayers certain questions to avoid the "don't ask, don't tell" scenario. The IRS should impose affirmative obligations on preparers to ask specific and carefully designed questions to ferret out relevant facts. For example, preparers could be required to ask self-employed taxpayers: "Did you receive any other income during the year that was not reported on a Form 1099?"[59] Once the preparer poses the questions to the taxpayer, the cause of any inaccuracies shifts from being an error of omission to an error of commission.[60] Some taxpayers and preparers who are willing to cut some corners will not be willing to cross that line. To give the due diligence requirements more force, the IRS should require the preparer to submit a signed due diligence statement with the return. By signing the statement under penalties of perjury, the preparer becomes more accountable and is reminded of his or her duty to the taxpayer and the tax system. To facilitate this

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57 The filing season generally runs from January 15 through April 15, or three months. There are about 60 work days in a three-month period. If an IRS employee were to visit one preparer in the morning and one preparer in the afternoon, the employee could conduct 120 visits during the three-month period. If 24 employees each conducted 120 visits, the total number of visits would be 2,880. Since each of these 24 employees would be conducting the visits for only three months, the hours translate to six FTE. In practice, additional costs would be incurred to create the program, develop and evaluate fact patterns, write up reports on the visits, cover travel expenses, etc. We cite this FTE data only to show that the costs should be manageable.

58 IRC §§ 6694(a)-(b), 6695(g). In 2003, the National Taxpayer Advocate made a legislative recommendation to increase the EITC due diligence requirements, including attaching a signed due diligence certification to the taxpayer's income tax return. *See* National Taxpayer Advocate 2003 Annual Report to Congress 270-301. The National Taxpayer Advocate also proposed that this issue be included on the 2009-2010 Guidance Priority List, but the IRS did not include it.

59 IRC § 6695(g) authorizes the IRS to impose due diligence requirements with respect to the EITC. The IRS should determine whether it has the legal authority to impose due diligence requirements in other areas or whether explicit statutory authorization would be required to do so. If legislation is required, the National Taxpayer Advocate recommends that Congress provide such authority.

60 National Taxpayer Advocate, *2009 IRS Research Conference* (June 2009); IRS Research Conference Papers: Elaine Doyle, *Cognitive Ethical Reasoning for Tax Practitioners: A Preliminary Investigation Using a Tax Specific Version of the Defining Issues Test (DIT)*; Leslie Book, *Increasing Preparer Responsibility, Visibility and Competence; Tax Preparers: Researchers Explore Tax Preparer Motives; More Due Diligence, Registration Urged*, BNA Daily Tax Report, July 10, 2009; National Taxpayer Advocate 2003 Annual Report to Congress 270-301; National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, 82 (Leslie Book, *The Need to Increase Preparer Responsibility, Visibility and Competence*).

process, the preparer should be able to submit the statement electronically with an e-filed return.[61]

Alternative and Progressive Treatments

The National Taxpayer Advocate believes the IRS should apply research-driven alternative enforcement treatments. The above-discussed IRS servicewide Return Preparer Strategy included an objective to "explore alternative compliance strategies with a goal of improving coverage of return preparers."[62] A good example is the multi-faceted preparer plan administered by the EITC program office, which includes graduated enforcement treatments and coordinates with other organizations for support, especially in the area of abusive return preparers.[63] Applying this plan servicewide, the IRS could initiate an enforcement action by sending a soft notice to the preparer and gradually increase the aggressiveness of the treatments.[64]

The use of soft notices by the IRS has increased EITC compliance. After taxpayers received notices in tax year 2002 advising them that a qualifying child's SSN was used by more than one person to claim EITC, approximately 28.4 percent of the taxpayers involved dropped the duplicate qualifying child in TY 2003. This initiative protected revenue of approximately $63.5 million.[65]

Ability of Taxpayers and IRS Employees to Report Preparer Noncompliance

In her 2006 Annual Report, the National Taxpayer Advocate raised concerns about the process of reporting complaints about preparers to the IRS.[66] TIGTA recently evaluated this process and identified similar concerns.[67] TIGTA found the IRS cannot determine how many complaints against preparers it receives, how many complaints are worked, or the total number of complaints against a specific firm or preparer.[68] Thus, it is imperative that any new preparer strategy require the IRS to track the complaint data. In addition, the IRS

61 As noted above, TAS submitted a proposal to include a revision of Treas. Reg. 1.6695-2(b) on the Guidance Priority List. Such revision would require preparers to sign an EITC due diligence certification and attach it to the taxpayer's income tax return.

62 IRS, *Return Preparer Strategy: Understanding and Partnering with the Return Preparer Community to Improve Voluntary Tax Compliance* 19 (Mar. 31, 2008).

63 IRS response to TAS information request (Oct. 2, 2009). The EITC Preparer Program includes initiatives to identify effective treatments that align with a preparer's level of noncompliant behavior that can become part of a progressive suite of treatments. In FY 2009, the EITC office partnered with SB/SE to test the effectiveness of four treatments: (1) Due Diligence Visits, (2) Knock and Talk Visits, which occur right before the commencement of the filing season, (3) First Time Paid Preparer Initiative, which tested the effect of different types of compliance touches, and (4) Streamlined Injunctions.

64 IRS, *Return Preparer Strategy: Understanding and Partnering with the Return Preparer Community to Improve Voluntary Tax Compliance*, 19-20 (Mar. 31, 2008). A study conducted by Inland Revenue of the United Kingdom found that the agency can encourage compliance merely by presenting itself as more involved in tax collection and aware of preparation activities. Thus, sending a soft notice may result in increased compliance if the IRS shows that it is aware of the preparer's activities. John Hasseldine, *Persuasive Communications: Tax Compliance Enforcement Strategies for Sole Proprietors*, 24 Contemporary Accounting Research 171 (2007).

65 IRS, *W&I Research, Soft Notice for Duplicate TINS for Tax Years 2002, 2003 and 2004*, Project Number 6-05-12-2-030E. *See also* IRM 21.5.10.4.2

66 National Taxpayer Advocate 2006 Annual Report to Congress 197-221.

67 TIGTA, Ref. No. 2008-400-15, *The Process Taxpayers Must Use to Report Complaints Against Tax Return Preparers Is Ineffective and Causes Unnecessary Taxpayer Burden* (Feb. 24, 2009).

68 Hearing Before the Subcomm. on Oversight, H. Comm. on Ways and Means (Feb. 26, 2009) (statement of J. Russell George, TIGTA).

should publicize and streamline the process for reporting problem preparers to enable both IRS employees and the public to easily submit complaints.[69]

Need for a Preparer Compliance Database

In her 2007 Annual Report, the National Taxpayer Advocate recommended that the IRS develop a preparer database that would include the number of returns prepared by each preparer and how often client returns contain various types of errors. Maintaining this type of information would allow the IRS to better target outreach and education as well as improve audit selection. The drawback to this approach is that some aggressive preparers may stop providing identifying numbers on returns if they discover the IRS is "profiling" them. On the other hand, taxpayers may visit less aggressive preparers if they believe these preparers carry a higher risk of audit.[70] The IRS can minimize the number of preparers and taxpayers "crossing the line" by taking the following steps: (1) imposing appropriate sanctions on preparers caught not using identifying numbers; (2) educating taxpayers that their preparer needs to sign the return and enter his or her identifying number; and (3) informing taxpayers that they cannot rely on a preparer's advice for purposes of abating penalties due to the reasonable cause exception if they go to a preparer who fails to properly register, sign the return, and provide the identifying number.

Access to Enrolled Agent and Enrolled Preparer Databases

The OPR should make an enrolled agent database available to both IRS employees and the public. The database should also include any additional preparers who register with the IRS if and when the IRS expands preparer registration requirements. IRS employees, practitioners, and the public would greatly benefit from access to this information. The database should be searchable and include such information as the preparer's contact information, whether the preparer is in good standing, the preparer's designation, if applicable, and any final determinations on disciplinary actions. State licensing agencies make this information available for other types of practitioners. The IRS should follow suit.

Research and Audit Selection

To target its preparer compliance activities more effectively, the IRS should research the causes of preparer errors. This research should evaluate, among other things, whether errors on returns are due to the individual preparer's independent actions or are a symptom of a firm's policies. Further, some errors are outside the preparer's control, such as when the preparer relies on the word of the taxpayer. This review should also address how the IRS determines which of the preparer's cases to review and whether it makes sense to freeze all of the preparer's returns.

69 Such public awareness campaign should also include information about using either Circular 230 practitioners or registered preparers.

70 National Taxpayer Advocate 2007 Annual Report to Congress 35-64.

In addition, once the IRS examines a preparer and finds no substantial problems, the IRS should adopt procedures to ensure that it does not repeatedly target that preparer absent changed circumstances. Because the IRS reviews clients' returns in the process, the IRS would be unfairly damaging the preparer's business reputation, as well as harming clients by delaying their refunds, if it continually targets a particular preparer even though previous audits found no significant problems.

CONCLUSION

As the IRS's position on return preparer oversight enters a critical stage, we encourage the IRS to develop a comprehensive servicewide strategy for preparer competence, visibility, and accountability. The National Taxpayer Advocate strongly urges the IRS to support a program to register, test, and certify unenrolled preparers. The disturbing findings of several recent studies involving mystery shopping visits provide compelling evidence that oversight of the industry requires significant transformation and increased rigor. There is widespread support for such a program in the preparer industry as well as Congress. The Office of the Taxpayer Advocate looks forward to working with the IRS as it continues to evaluate this issue and develop recommendations for much needed change.

In light of our longstanding proposals and a few additional proposals, the National Taxpayer Advocate offers these preliminary recommendations:

1. Develop and implement a Servicewide Return Preparer Strategy.
2. Create an executive steering committee and a program office, both under the jurisdiction of the Deputy Commissioner (Services and Enforcement), to assume responsibility for development of policies and procedures as well as continual monitoring duties regarding administration and technical interpretation of the tax provisions under Title 26. The Taxpayer Advocate Service and the Office of Professional Responsibility (OPR) should have representation on the cross-functional steering committee along with the other business functions. OPR would have oversight responsibility for registration, testing, CPE, and Circular 230 sanctions as it already does for enrolled agents.
3. Require all persons who prepare tax returns to obtain and use a unique preparer identifying number (PTIN).
4. Develop a system to systematically validate PTINs on all tax returns.
5. Develop and implement a registration, examination, certification, and enforcement program for unenrolled preparers, including a periodic CPE requirement. Examinations should be given at two levels: (1) basic Form 1040 issues and (2) more complex Form 1040 issues and business returns. It is important that the second-level exam include topics germane to the preparation of business returns, including non-Form 1040 series returns, to address the high level of noncompliance on S corporation and other business returns. Both the exams and CPE courses should include ethics components.

6. Apply the registration, testing, and CPE requirements to any preparer who substantially interacts with a taxpayer and prepares the taxpayer's tax return. Limiting the requirements solely to preparers who sign returns would enable a significant (and growing) portion of the preparer population to prepare tax returns without registering, passing a test to demonstrate knowledge, or taking CPE courses to remain up-to-date on tax law changes.
7. Conduct strategic research to determine the various types of noncompliance as well as the reasons and appropriate treatment for each type of noncompliance.
8. Conduct a public awareness campaign over a period of years to inform taxpayers of preparer signature, PTIN and registration requirements, if applicable, as well as procedures to file complaints against preparers.
9. Make the enrolled agent database and any potential future registered preparer database available to both IRS employees and the public.
10. Implement a large-scale mystery shopper program, using scenarios carefully designed to incorporate fact patterns addressing areas of substantial noncompliance.
11. Impose due diligence requirements on preparers relating to identified areas of significant noncompliance. Such requirements should require preparers to sign due diligence statements and attach the statements to the taxpayers' returns, including e-filed returns.

IRS COMMENTS

In June 2009, the Commissioner launched a comprehensive review of return preparers in an effort to help the IRS better leverage this community with the twin goals of increasing taxpayer compliance and ensuring uniform and high ethical standards of conduct for preparers. This was a large undertaking by the Commissioner, who committed to this effort and focused a team of resources to review all input from outside stakeholders as well as within the IRS and other federal agencies. The National Taxpayer Advocate's office was included in this review and participated in the development of final recommendations that will be announced and issued by the Commissioner in the near future.

It was clear to the IRS that a Servicewide Return Preparer Strategy and an increase in the oversight of return preparers were warranted. Unethical and unqualified return preparers can harm taxpayers and challenge the integrity of the tax system.

Return preparers are key partners in tax administration. The IRS Strategic Plan for 2009 – 2013 documents the importance of return preparers in two objectives: 1) Strengthen partnerships with tax practitioners, tax return preparers, and other third parties in order to ensure effective tax administration, and 2) Ensure that all practitioners, tax return preparers and other third parties in the tax system adhere to professional standards and follow the law.

The review was comprehensive and gathered opinions and input from a broad range of external and internal stakeholders. Many organizations were represented in three public forums held with consumer groups, tax professional organizations, federal and state government agencies and other groups to provide opportunities for open dialogue. The IRS also requested public comments regarding possible oversight of tax return preparers. Approximately 500 comments were received via this method. Additionally, almost 600 comments were received from IRS employees and managers.

This review entailed reviewing all potential options around registration, testing, enforcement, ethics and education, as well as the comments received from the public and external stakeholders above. There was widespread consensus on the necessity for increased oversight of return preparers. Each of these issues will be addressed at length in the Commissioner's final report and recommendations which are scheduled for release in the near future.

Taxpayer Advocate Service Comments

In General

The National Taxpayer Advocate commends the IRS for conducting a comprehensive return preparer review for the purpose of strengthening oversight over return preparers. The Office of the Taxpayer Advocate played an active role in the review and agreed with many, although not all, of its final recommendations. Because the IRS has not formally issued its report at this writing, we will reserve detailed comments on the report until it is released.

As noted by the IRS, information gathered during the data collection stage of the review confirms widespread support for improving oversight of return preparers. In addition, the findings of several recent studies involving undercover shopping visits provide compelling evidence that such increased oversight would substantially benefit both taxpayers and tax administration.

The National Taxpayer Advocate reiterates her longstanding recommendation that the IRS develop and implement a program to register, test, and certify unenrolled return preparers and require that they remain current on tax law changes by completing periodic continuing professional education courses. Eligibility examinations should be offered at least at two levels – the first level should cover issues germane to preparing basic Form 1040 returns and the second level should cover more complex Form 1040 and business entity issues. The IRS should couple its oversight program with a comprehensive public awareness campaign targeted at both the taxpaying public and preparers subject to the new rules.

The New Rules Should Apply to All Persons Who Prepare Tax Returns – Not Merely to "Signing" Preparers.

The National Taxpayer Advocate believes that to be effective, registration requirements should apply to all tax return preparers and that testing and CPE requirements should apply to all unenrolled preparers who interact with taxpayers and prepare returns.[71] This is a critical point. At first blush, one might assume that a "comprehensive" tax return preparer strategy would automatically cover all tax return preparers, but that is not necessarily the case. Treasury regulations distinguish between a preparer who signs a tax return (a "signing tax return preparer") and a preparer who prepares "all or a substantial portion" of a tax return but does not sign it (a "nonsigning tax return preparer").[72]

In some tax return preparation businesses, one or a small number of preparers are designated to sign all returns, yet multiple preparers conduct substantive interviews and meetings with taxpayers and either prepare their returns or prepare reports of the interviews and the data upon which the returns are based. In these cases, the "signing tax return preparer" often will not have met with the taxpayer, had an opportunity to ask questions of the taxpayer, or reviewed the taxpayer's documentation. If the IRS regulates solely "signing tax return preparers," many individuals engaged in return preparation will not be subject to registration, testing, CPE, or other requirements. This would leave a gaping hole in the regulatory regime that could be widely and increasingly exploited and that could thereby undercut the effectiveness of the initiative.

There are significant, compelling reasons to require that all persons who prepare tax returns – including nonsigning preparers – be included within the scope of the new rules. Among these reasons are the following:

1. **It would enable the IRS to achieve the consumer protection objective of the initiative by requiring all unenrolled preparers to pass an entrance exam and take CPE courses.** Because unenrolled preparers currently do not have to satisfy any education or testing requirements to demonstrate that they possess basic knowledge about return preparation, the National Taxpayer Advocate has consistently recommended that they be required to pass an examination before preparing tax returns and that they then be required to take periodic CPE courses. Low income and limited English proficiency taxpayers are particularly likely to rely on unenrolled preparers. Thus,

71 We have not recommended that attorneys and CPAs be required to comply with testing and CPE requirements because they have completed professional education, have passed professional examinations, and typically must comply with ongoing CPE requirements. It is also our understanding that the IRS lacks the legal authority to require attorneys and CPAs to take examinations or CPE as a condition of practice. *See* 5 U.S.C. § 500(b) & (c). Similarly, we have not recommended that Enrolled Agents be required to comply with additional testing and CPE requirements because Enrolled Agents already must register with the IRS, pass an examination, and comply with CPE requirements.

72 Treasury regulations define a "nonsigning tax return preparer" as "any return preparer who is not a signing tax return preparer but who prepares all or a substantial portion of a return or claim for refund . . .". Treas. Reg. § 301.7701-15(b)(2). A "signing tax return preparer" is defined as "the individual tax return preparer who has the primary responsibility for the overall substantive accuracy of the preparation of such return or claim for refund." Treas. Reg. § 301.7701-15(b)(1). Thus, it is entirely permissible for someone who prepares "all" of a tax return to be considered a nonsigning preparer so long as someone else has the primary responsibility for the overall substantive accuracy of the return.

if unenrolled nonsigning preparers are excused from testing and CPE requirements, the requirements will fail to protect a significant and largely vulnerable segment of the taxpaying public. It is important to note that any new testing and CPE requirements are likely to apply *solely to* unenrolled preparers – not to attorneys, CPAs, and Enrolled Agents.[73] Therefore, the principal effect of exempting nonsigning preparers from the new rules would be to excuse *unenrolled* nonsigning preparers from examination and CPE requirements.

2. **It would strengthen the IRS's ability to detect preparer-facilitated noncompliance via automation.** A significant benefit of tracking preparers by PTIN is that it should allow the IRS to associate preparers with the returns they prepare using automated systems and thereby enable the IRS to identify preparers with disproportionately high risk scores. The results of the GAO and TIGTA studies cited above suggest that the revenue loss attributable to preparer-facilitated noncompliance amounts to billions of dollars, potentially tens of billions of dollars, each year. Some of the errors reflect negligence, while others are willful. If each person who prepares a tax return has a unique identifying number, the IRS will be much better able to identify preparers who submit consistently noncompliant returns.[74] As discussed more fully below, if only "signing tax return preparers" are required to register, an incentive will arise for more preparers to become "nonsigning tax return preparers." As a consequence, fewer returns will bear the PTIN of the individual who prepared them, reducing IRS's ability to detect and deal with noncompliant preparers.[75]

3. **It would allow the IRS to undertake a public information campaign with a simple message that taxpayers can understand.** The National Taxpayer Advocate believes that the IRS should issue certificates to all persons registered to prepare tax returns and make available a searchable, online database of registered preparers as well. If all preparers are required to register, the public message is simple: "Only persons who display an IRS certificate and are listed in the database are authorized to

[73] As noted above, the IRS apparently lacks the legal authority to require attorneys and CPAs to take examinations or CPE as a condition of practice (*see* 5 U.S.C. § 500(b) & (c)), and Enrolled Agents already must register with the IRS, pass an examination, and comply with CPE requirements.

[74] Assume, for example, that a return preparation business employs ten preparers. To avoid the costs and burdens associated with registration, testing, and CPE, the business arranges for one individual to become licensed to sign all returns and employs the other nine individuals as nonsigning preparers. Assume further that there are two preparers who consistently prepare inaccurate returns. If each of the ten preparers was registered, each preparer would be likely to sign the returns he himself prepared. That would make it much easier for the IRS to identify the two deficient preparers via automated compliance checks. But if the returns prepared by all ten preparers are submitted under the PTIN of the sole signing preparer, the signing preparer's risk score would reflect a blend of the return scores associated with the eight compliant preparers and the two noncompliant ones. As a result, the blended risk score may fall within the range of acceptable scores and the IRS will have missed an opportunity to identify the deficient preparers, potentially harming taxpayers and tax compliance.

[75] Even if nonsigning preparers are required to obtain PTINs, there still will be some occasions where a nonsigning tax return preparer prepares a return but a signing tax return preparer assumes the responsibility for its substantive accuracy. At a CPA firm, for example, multiple CPAs may prepare returns, yet a limited number of partners may be authorized to assume responsibility for the overall accuracy of returns and therefore to sign them. If nonsigning preparers are required to register, however, we believe return preparers will sign the returns they themselves prepare in a much larger number of cases and we think the circumstances under which there is a separate signing preparer are less likely to be problematic. First, because nonsigning preparers would have to register with the IRS and meet whatever testing and CPE requirements are prescribed, the goal of ensuring competence and accountability would be achieved. Second, nonsigning preparers would be *eligible* to sign tax returns, so unlike in situations where a nonsigning preparer is not registered or authorized to sign a return, the signing preparer would not be signing the return simply because there is no other option. His signature would more likely reflect a management decision to make him the responsible person for reasons of competence and experience.

prepare your return." If the IRS exempts nonsigning preparers from the regulatory requirements, the message will be more complex and less likely to stick. ("The person who prepares your tax return does not have to be registered, but the person who signs your return, who may or may not be the person who prepares it and whom you may or may not meet, must display an IRS certificate"?)

4. **It would enable the IRS to enlist taxpayers in enforcing the registration requirement and reduce the ability of preparers to operate "underground."** Taxpayers should be the most effective and efficient enforcement agents of the new rules because if they decline to use unregistered preparers, the preparers will go out of business. This is critical, because the IRS lacks the resources to enforce the rules effectively on its own. However, taxpayers can only be effective enforcement agents if they have an easy way to distinguish a preparer who may legally prepare a return from a preparer who may not. If all preparers are required to display a registration certificate, taxpayers can be educated to avoid any preparer without one. By contrast, if nonsigning preparers are permitted to prepare returns without a registration certificate, the benefits of taxpayer enforcement would be largely lost. On a related note, the IRS should take steps to minimize the number of preparers who avoid the new requirements by operating "underground" (*i.e.,* preparing returns for a fee but leaving the signature line blank, thus remaining invisible to the IRS). Requiring all preparers to comply with the regulatory requirements and making clear to taxpayers that they should only use preparers who display a registration certificate and sign the return would limit the ability of unscrupulous preparers to operate outside the new rules.

5. **It would create a mechanism to prevent deficient preparers from moving from one job to another.** If all preparers are required to register and the IRS maintains a searchable database of authorized preparers, return preparation businesses could check a job applicant against the IRS database to confirm that the applicant is registered. If nonsigning preparers are permitted to prepare tax returns without registering, however, there will be no easy way for return preparation businesses to determine who has been subject to disciplinary action and who has not. As a consequence, deficient preparers could move from one job to another without being tracked.

6. **It would facilitate verification of due diligence requirements.** The National Taxpayer Advocate has recommended that preparers be directed to ask taxpayers a limited number of "due diligence" questions relating to high noncompliance areas when completing returns. For example, IRS research shows that a high percentage of sole proprietorship income is not reported. Therefore, the preparer of a Form 1040, Schedule C, *Profit or Loss From Business (Sole Proprietorship),* could be directed to ask the taxpayer: "Did you receive any other business income that was not reported to you on a Form 1099?" In our view, the preparer who conducts this "due diligence interview" should be directed to record the answers on a separate certification

form (which may be e-filed along with the return) and should be required to sign the certification form and include his PTIN – even if the overall return is to be signed by another preparer. Requiring the preparer who asks the due diligence questions to certify compliance will reduce instances where questions are either skipped or handled with a nudge and a wink. However, this requirement would not be practical if nonsigning preparers who meet with taxpayers and conduct due diligence interviews do not have a PTIN.

7. **It would facilitate IRS's ability to conduct effective undercover shopping visits.** As discussed above, the National Taxpayer Advocate has recommended that the IRS conduct preparer shopping visits. However, if an IRS employee visits a nonsigning preparer and the preparer does not display a certificate listing his name and PTIN, the IRS employee may not be able to identify the preparer. Even if the IRS employee does learn the preparer's name, there will be no easy way to identify other returns the preparer has completed in cases where compliance problems are identified.

8. **If nonsigning tax return preparers are excused from the new rules, we likely will end up with more nonsigning preparers.** If nonsigning preparers are excused from the new regulatory requirements, an incentive will arise for more return preparation businesses to adopt the model of using multiple nonsigning preparers. If preparers are required to pay user fees, pass an entrance exam, and comply with annual CPE or other requirements, the preparers (or their employers) will bear new costs and burdens. The IRS weighed the impact of these costs and burdens carefully in recent months and determined (correctly, in our view) that the public benefits of preparer regulation outweigh its costs. However, it is all but certain that more businesses will choose to use nonsigning preparers, if that is an available option, to reduce their costs and compliance burdens. And over time, as these businesses under-price their competitors, competitive pressures are likely to drive more tax preparation businesses to adopt this same model of using "nonsigning tax return preparers," which will result in a growing segment of the preparer population that operates outside any registration, testing, and CPE requirements.

For the foregoing reasons, we believe it is critical that the new rules apply to all tax return preparers, and we are concerned that excluding nonsigning preparers could create an exception that swallows the rule.

We Find the Arguments for Excluding All Nonsigning Preparers from the New Rules to Be Unpersuasive.

We have had many discussions about this issue and heard four arguments advanced for limiting the scope of the initiative to signing tax return preparers. We find the arguments unpersuasive and in some cases contradictory.

First: It has been argued that very few return preparation businesses are operating under the model of using one or several signing preparers and multiple nonsigning preparers.

While there is no way to quantify the extent of the practice, the National Taxpayer Advocate believes that the practice is fairly widespread. More important, we think this argument misses the point. On the one hand, if almost all return preparation businesses require the person who prepares a return to sign it, then the universe of "nonsigning" preparers who are preparing tax returns is very small and including such individuals in the regulatory regime would impose limited burden. On the other hand, if return preparation businesses are widely using a model that includes nonsigning preparers, then the need to include nonsigning preparers within the regulatory regime is even more important. Moreover, as noted above, the new regime will itself provide a strong incentive for return preparation businesses to move to that model to reduce costs and burden, so the IRS should act now to avoid creating a loophole.

Second: It has been argued that including nonsigning preparers in the regulatory regime will require more resources than the IRS can reasonably devote to this project. As a threshold matter, we note that the premise of this argument contradicts the prior argument. It cannot logically be argued both that (1) return preparation businesses do not use nonsigning preparers to prepare tax returns and (2) there are so many nonsigning preparers that it will overburden the IRS's resources to register and test them.

More to the point, the IRS is authorized to charge user fees to cover the costs of administering the return preparer program, and it can set the fees at whatever level is required to include nonsigning preparers within its scope.[76] To illustrate, assume that there are one million signing preparers and 200,000 nonsigning preparers. If the IRS includes nonsigning preparers within scope, it arguably will have to build systems that have 20 percent greater capacity, and it will have to hire 20 percent more employees in the program office to handle paper and related work. The IRS should be able to recover these additional costs through user fees. The user fee charged per preparer may even be lower if nonsigning preparers are included because the nonsigning preparers would also pay user fees, potentially resulting in economies of scale.

If there are significant program costs that the IRS cannot legally or practically recover through user fees, it should work with the Treasury Department and the Office of Management and Budget to request additional funding. It would be unfortunate if the desire to conserve resources leads the IRS to squander resources by developing an extensive registration, testing, CPE, and certification regime that fails to address the category of preparers that creates the largest risk for taxpayers and tax compliance (*i.e.,* unenrolled preparers and particularly nonsigning unenrolled preparers, who are invisible to the IRS).

Third: It has been argued that the IRS can effectively address problems associated with nonsigning preparers by holding their employers or the signing preparers accountable for mistakes. In our view, this would not be an effective approach for several reasons:

[76] *See* 31 U.S.C. § 9701.

- The signing preparer will not necessarily have access to complete information. For example, if the nonsigning preparer who met with the taxpayer has helped the taxpayer claim an ineligible child for purposes of the earned income tax credit or has encouraged a taxpayer to consider omitting items of gross income because no Form 1099 was issued and the IRS therefore will not be able to detect the omission, the signing preparer will have no way to identify those inaccuracies based on a review of the return. Significantly, these examples are not just theoretical. Both occurred during the GAO and TIGTA shopping visits described above.
- The IRS will only be able to detect and penalize a small percentage of problematic employers, because someone would have to report an employer to the IRS and the IRS would have to conduct a resource-intensive investigation. By contrast, the benefit of giving every preparer a PTIN is that the IRS could identify more preparers by automation and could therefore take more compliance actions at a lower cost.
- As discussed above, if nonsigning preparers are excused from the new rules, a nonsigning preparer penalized by the IRS or dismissed by one business for incompetence could walk across the street and apply for work at another business. Without a requirement that nonsigning preparers have a PTIN or certificate (which the IRS could revoke) and be listed on a searchable database of registered preparers, the second business will have no easy way to know that the individual is not qualified. As a consequence, incompetent or unethical preparers will have an easier time continuing to prepare returns by "hiding" as nonsigning preparers and moving from job to job.
- A signing preparer will not always have supervisory responsibility over other preparers in the business. For example, assume the owner of a return preparation business hires one person (whom he pays to register as a licensed tax return preparer) to serve as his "signing tax return preparer" and assume he hires multiple "nonsigning tax return preparers." If the signing tax return preparer is directed to sign returns for all other preparers as a condition of maintaining his job, he may well do it. The need for a job – particularly in the current economy – is a certain and immediate concern that is likely to outweigh the theoretical risk that the IRS may identify a compliance problem at some point in the future.

Fourth: It has been argued that the definition of a "nonsigning tax return preparer" is very broad and includes certain categories of practitioners who are not involved in return preparation, such as attorneys or CPAs who provide solely pre-transactional tax advice, or that the new rules could impose undue burden on law or accounting firms. We agree that it may not be appropriate to require everyone included within the definition of a "nonsigning tax return preparer" to register with the IRS as a preparer. However, the decision about whether to include nonsigning preparers within the scope of regulation need not be an all-or-nothing proposition. The IRS can easily write rules to include only a subset of "nonsigning tax return preparers." Specifically, the IRS could reasonably decide to include only preparers who actually prepare tax returns within the new regulatory regime. One way

to implement this approach would be to require registration by (1) all signing tax return preparers and (2) nonsigning tax return preparers who prepare all or a substantial portion of a tax return or claim for refund. Alternatively, if the IRS is concerned that the new rules would create undue burden for law or accounting firms, the rules could apply to (1) all signing tax return preparers and (2) all nonsigning tax return preparers except attorneys and CPAs.

Conclusion

On balance, we commend the IRS for undertaking this significant, far-reaching initiative regarding return preparer oversight. We believe it has the potential to provide significant protection and reassurance to the majority of the taxpaying public that relies on paid tax return preparers and to improve tax compliance as well. We look forward to continuing to work with the IRS toward these ends as the strategy is refined and implemented.

Our recommendations, formulated prior to the time the IRS finalized its return preparer strategy, are listed immediately below.

Recommendations

To increase preparer competence, visibility, and accountability, the National Taxpayer Advocate offers the following administrative recommendations:

1. Develop and implement a Servicewide Return Preparer Strategy.
2. Create an executive steering committee and a program office, preferably under the jurisdiction of the Deputy Commissioner (Services and Enforcement), to assume responsibility for development of policies and procedures as well as continual monitoring duties regarding administration and technical interpretation of the tax provisions under Title 26 relating to the return preparer strategy. The Taxpayer Advocate Service and the Office of Professional Responsibility (OPR) should have representation on the cross-functional steering committee along with other affected business functions. OPR should have oversight responsibility for registration, testing, CPE, and Circular 230 sanctions, as it already does for enrolled agents.
3. Require all persons who prepare tax returns to obtain and use a unique preparer identifying number (PTIN).
4. Develop a system to systematically validate PTINs on all tax returns.
5. Develop and implement a registration, examination, certification, and enforcement program for unenrolled preparers, including a periodic CPE requirement. Examinations should be offered at least at two levels: (1) basic Form 1040 issues and

(2) more complex Form 1040 issues and business returns. The second-level exam should include business issues arising both on Form 1040 exams (*e.g.,* Schedule C) and on other entity returns to address the high level of noncompliance on S corporation and other business returns. Both the exams and CPE courses should include ethics components.

6. Apply the registration, testing, and CPE requirements to any preparer who substantially interacts with a taxpayer and prepares the taxpayer's tax return. Limiting the requirements solely to preparers who sign returns would enable a significant (and growing) portion of the preparer population to prepare tax returns without registering, passing a test to demonstrate competence, or taking CPE courses to remain up-to-date on tax law changes.
7. Conduct strategic research to determine the various types of noncompliance as well as the reasons and appropriate treatment for each type of noncompliance.
8. Conduct a public awareness campaign over a period of years to inform taxpayers of preparer signature, PTIN and registration requirements as well as procedures to file complaints against preparers.
9. Issue a certificate to each certified preparer and create a searchable online database of all certified preparers to enable taxpayers (and potential employers) to readily identify them. The database should also include the preparer's status (*e.g.,* attorney, CPA, Enrolled Agent, or unenrolled preparer).
10. Implement a large-scale program of preparer visits, using scenarios carefully designed to determine the treatment of areas that typically result in high noncompliance rates.
11. Impose due diligence requirements on preparers relating to identified areas of significant noncompliance. Such requirements should require preparers to sign due diligence statements and attach the statements to the taxpayers' returns, including e-filed returns.

MSP #4 Appeals' Efficiency Initiatives Have Not Improved Taxpayer Satisfaction or Confidence In Appeals

RESPONSIBLE OFFICIAL

Diane Ryan, Chief, Appeals

DEFINITION OF PROBLEM

The Office of Appeals (Appeals) provides a vital service to taxpayers. Its mission is to act as an independent arbiter to protect taxpayer rights and foster voluntary tax compliance by offering a fair and timely forum for the government and taxpayers to resolve their differences.[1] In fiscal year (FY) 2008, Appeals received more than 115,000 new cases, resolving over 52 percent of its docketed cases and nearly 64 percent of its non-docketed ones.[2] Since 2002, Appeals has improved its speed in resolving cases.[3]

In 2004, Appeals implemented its Campus Specialization Initiative (CSI), seeking to improve the appeals process (*i.e.*, cycle time), and tailor interaction with taxpayers to efficiently resolve their issues.[4] In past Annual Reports to Congress, the National Taxpayer Advocate expressed concern that CSI might enable Appeals to process cases faster at the expense of taxpayer service.[5] Since then, Appeals reduced cycle time on its non-docketed cases and appears to be meeting its staffing challenges, but with little improvement in its customer satisfaction ratings.[6]

The National Taxpayer Advocate is concerned that Appeals' efficiency initiatives undermine its effectiveness and diminish its unique ability to listen to taxpayers and settle their cases.[7] Chief among her concerns:

- The overall customer satisfaction rate for Appeals is low (65 percent) and satisfaction with campus Appeals operations was lower than for its field offices in FY 2007 and FY 2008.[8]

1 Internal Revenue Manual (IRM) 8.1.1.1 (Oct. 23, 2007).

2 Appeals Inventory Report, AIR-One, cumulative through Sept. 30, 2007 and Sept. 30, 2008. Docketed cases are those in which the taxpayer has filed a petition with the Tax Court.

3 Appeals, *Business Performance Review* 11 (Feb. 19, 2009).

4 Appeals, *Strategic Plan FY 2008-2013* 2; Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2007-10-071, *The Office of Appeals Needs to Improve the Monitoring of Its Campus Operations Quality* 1 (May 10, 2007); National Taxpayer Advocate 2006 Annual Report to Congress 266-67.

5 National Taxpayer Advocate 2006 Annual Report to Congress 266-88; National Taxpayer Advocate 2005 Annual Report to Congress 136-61; National Taxpayer Advocate 2004 Annual Report to Congress 264-89.

6 IRS response to TAS information requests (July 1, 2009).

7 Appeals, *Business Performance Review* 11 (Feb. 19, 2009).

8 IRS, *Appeals Customer Satisfaction Survey, National Report FY 2008* 12, 17 (Feb. 2009).

- Forty-seven percent of unrepresented taxpayers were other than satisfied with Appeals in FY 2008.[9]
- Despite the requirements of § 3465 (b) of the IRS Restructuring and Reform Act of 1998 (RRA 98), nine states have no appeals officers or settlement officers.[10]
- Appeals' delays in handling cases range from 30 days to 20 months.[11]
- Customer satisfaction ratings for Appeals' fairness in resolving cases and its consideration of information presented by taxpayers have declined by nine percent and ten percent, respectively, from October 2005 through September 2008.[12]
- Appeals has not conducted a taxpayer-based assessment to consider the taxpayers' conference needs or preferences (e.*g.*, campus, local, telephonic, correspondence, or in person).

ANALYSIS OF PROBLEM

Background

Before the enactment of RRA 98, most Appeals cases involved audit and penalty assessment hearings or court docketed cases.[13] Since 1998, Appeals case receipts have substantially increased.[14] RRA 98 established appeals for review of lien or levy collection due process (CDP), rejection of offers in compromise (OIC), rejection or termination of installment agreements (IA), and additional appeal rights for nonrequesting spouses in innocent spouse cases.[15]

Appeals adopted campus specialization to work certain cases at IRS campus locations to reduce cycle time and aging inventories.[16] Before that, Appeals worked most cases from offices closest to the taxpayer's residence or place of business.

There are settlement or appeals officers in more than 70 cities and in six campuses (Brookhaven, NY, Covington, KY, Fresno, CA, Memphis, TN, Ogden UT, and Philadelphia,

9 IRS, *Appeals Customer Satisfaction Survey, National Report FY 2008* 13 (Feb. 2009). Of the 47 percent of unrepresented taxpayers who were other than satisfied with Appeals, 27 percent said they were dissatisfied, and 20 percent said they were neither satisfied nor dissatisfied.

10 IRS, Human Resources Reporting Center, *Organizational Location Reports* (Sept. 26, 2009).

11 IRS, *Appeals Quality Measurement System Appeals (All Areas) Results Report FY 2008* 3 (Dec. 4, 2008).

12 IRS, *Appeals Customer Satisfaction Survey National Report FY 2008 Results* 27-28 (Feb. 2009).

13 Pub. L. No. 105-206, 112 Stat. 685 (1998); TIGTA, Ref. No. 2007-10-071, *The Office of Appeals Needs to Improve the Monitoring of Its Campus Operations Quality* 1 (May 10, 2007).

14 IRS Data Book, Table 22 (1998); IRS Data Book, Table 21 (2008).

15 Pub. L. No. 105-206, 112 Stat. 685 (1998). *See* IRS Pub. 1660 (Mar. 2007) at 1 (collection due process allows taxpayers to appeal a collection action under IRC §§ 6320 or 6330 after the IRS files a notice of federal tax lien or before a levy is served); IRS Pub. 594 (July 2007) at 6 (the IRS may accept an offer in compromise to settle unpaid tax accounts for less than the full amount of the balance due under IRC § 7122); Pub. 594 (July 2007) at 5 (taxpayers may be permitted to pay their liabilities in monthly installments under IRC § 6159); Pub. 971 (Apr. 2008) at 1 (spouses or former spouses may be entitled to innocent spouse relief, relieving them of the tax, penalty, and interest on a joint return under IRC § 6015). The new innocent spouse provisions enacted in RRA 98 resulted in a major influx of innocent spouse appeals. IRS, *Non-Docketed Service Advice Review*, 1999 IRS NSAR 11116 (July 9, 1999).

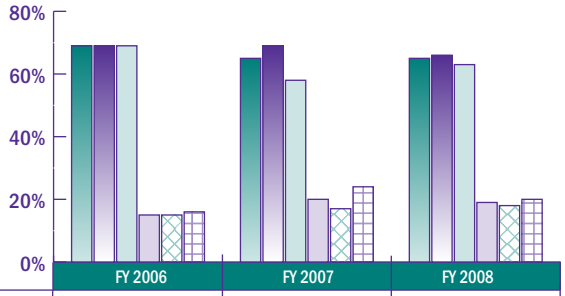
16 Appeals, *Business Performance Review* 4, 5, 19 (Feb 19, 2009).

PA).[17] Appeals works seven distinct types of cases (*i.e.*, workstreams) at its campuses: CDP hearings, OIC, innocent spouse, penalty abatement requests, non-docketed examinations, S-docketed examinations, and Freedom of Information Act (FOIA) requests. Appeals conducts hearings with taxpayers or their representatives by correspondence or telephone, but will hold face-to-face hearings if requested by the taxpayer.[18]

Appeals' customer satisfaction survey shows a decline in taxpayer service.

Appeals' customer satisfaction rate is low – hovering around 65 percent. From FY 2006 to FY 2008, Appeals emphasized that improving its processes and cycle time was paramount to improving taxpayer service.[19] However, its customer satisfaction surveys for the same period suggest that improving timeliness does not have an effect on overall customer satisfaction.[20] As Table 1.4.1 shows below, Appeals' overall customer satisfaction results declined and customer dissatisfaction rose. Customer satisfaction rates for field offices are higher and dissatisfaction rates are lower than campuses.

TABLE 1.4.1, Appeals' Customer Satisfaction, Overall and Campus vs. Field[21]



	FY 2006	FY 2007	FY 2008
Overall Satisfaction	69%	65%	65%
Field Satisfaction	69%	69%	66%
Campus Satisfaction	69%	58%	63%
Overall Dissatisfaction	15%	20%	19%
Field Dissatisfaction	15%	17%	18%
Campus Dissatisfaction	16%	24%	20%

17 IRS, Human Resources Reporting Center, *Organizational Location Reports* (Sept. 26, 2009).

18 IRM 8.4.2.3 (Oct. 30, 2007); IRM 8.22.2.2.6.4 (Mar. 11, 2009); IRM 8.23.2.2.1 (Aug. 28, 2009). Face-to-face conferences are not offered for taxpayers who only raise frivolous or groundless issues. IRM 8.6.1.4 (May 5, 2009).

19 Appeals, *Strategic Plan FY 2006-2009* 4; Appeals, *Business Performance Review* 23 (Feb. 19, 2009).

20 IRS, *Appeals Customer Satisfaction Survey National Report, FY 2008 Results* 6 (Feb. 2009); IRS, *Appeals Customer Satisfaction Survey National Report, FY 2007 Results* 6 (Mar. 2008); IRS, *Appeals Customer Satisfaction Survey, National Report FY 2006 Results* 5 (May 2007).

21 IRS, *Appeals Customer Satisfaction Survey, National Report FY 2006 Results* 4, 13 (May 2007); IRS, *Appeals Customer Satisfaction Survey, National Report FY 2007* 9 (Mar. 2008); IRS, *Appeals Customer Satisfaction Survey, National Report FY 2008* 5, 12, 17 (Feb. 2009).

From FY 2006 to FY 2008, Appeals cycle time improved from 146 to 143 days for campus cases, and from 302 to 220 days for field cases.[22] In the same period, Appeals reduced the average hours per case by almost an hour.[23] Yet these savings have not improved taxpayer satisfaction. Rather, Appeals' customer satisfaction surveys indicate that poor communication, untimely service, and deteriorating relationships with taxpayers are its greatest problems.

Poor communication with taxpayers, especially low income taxpayers, leads to low customer satisfaction and may not resolve taxpayers' issues.

> "Make it (communication) more conscientious. Consolidation is making it difficult to communicate with local IRS. Phone accessibility is almost impossible."[24]

Poor communication by Appeals harms taxpayers and deprives them of fair and impartial hearings. In 2007, TIGTA found Appeals failed to provide taxpayers with their right to a CDP hearing because Appeals made insufficient efforts to contact taxpayers before closing their cases. TIGTA could not determine whether all taxpayers' issues were addressed because Appeals' documentation was missing or incomplete. TIGTA also found that Appeals' letters to taxpayers were not always accurate or clear, or did not fully address taxpayers' issues.[25] In another report, TIGTA found that in some cases Appeals failed to notify the nonrequesting spouse of his or her right to participate in the joint and several liability proceeding.[26]

Customer satisfaction for unrepresented taxpayers has fallen from 61 percent in FY 2006 to 54 percent in FY 2008.[27] Appeals' failure to inform taxpayers of representation options or to require employees to educate unrepresented taxpayers about the Appeals process may be causing this growing disparity. The Uniform Acknowledgement Letters (UALs) that confirm Appeals' receipt of taxpayers' hearing requests do not tell taxpayers about Low Income Taxpayer Clinics (LITCs) or TAS.[28] This information is critical to taxpayers disputing adjustments to their claimed Earned Income Tax Credit (EITC), because these taxpayers, when represented, are twice as likely to be determined eligible for the EITC.[29]

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22 IRS response to TAS information request (July 1, 2009).

23 Appeals, *Business Performance Review* 11 (Feb. 19, 2009).

24 IRS, Appeals Customer Satisfaction Survey National Report FY 2008 Results, *Specific Suggestions from Customer Comments* 10 (Feb. 2009).

25 TIGTA, Ref. No. 2007-10-139, *The Office of Appeals Has Improved Its Processing of Collection Due Process Cases* 2-7 (Sept. 21, 2007).

26 TIGTA, Ref. No. 2007-10-071, *The Office of Appeals Needs to Improve the Monitoring of Its Campus Operations Quality* 9-10 (May 10, 2007). IRC § 6015(h)(2) requires the nonrequesting spouse be notified and given an opportunity to participate in the administrative proceedings for claims filed under IRC § 6015.

27 IRS, *Appeals Customer Satisfaction Survey National Report FY 2008 Results* 13 (Feb. 2009). Satisfied taxpayers were either very or somewhat satisfied with Appeals.

28 *See* IRS Letter 4141, *Acknowledgment Letter* (Sept. 2009); IRS Letter 4031(CG), *Campus Penalty Appeals Uniform Acknowledgement Letter* (Oct. 2005); IRS Letter 3808(CG), *S-Docketed Initial Contact Letter* (Aug. 2005).

29 National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 108.

Untimely service to taxpayers further erodes satisfaction.

> "One of my biggest complaints is that Appeals will ask for data, give a short time to produce it, get it, sit on it for weeks or even months and then want the data again because it is old. This is very costly and upsets the taxpayer."[30]

Taxpayers expect the IRS to notify them of delays and give them a reasonable estimate of time for their appeal. Appeals' campuses have delayed taxpayers' cases by one to three months in the acknowledgement and processing of CDP cases, one to ten months in OIC cases, seven to 13 months in innocent spouse cases, and six to eight months in penalty cases.[31] According to Appeals' quality measurement, Appeals continues to find periods in cases, ranging from 30 days to 20 months, without any documented contact by Appeals employees.[32]

Delays in case handling create downstream issues such as amended return filings, multiple calls, taxpayer uncertainty, additional penalty and interest charges, TAS referrals, and the loss of confidence in the appeals process. Appeals should conduct non-evaluative early intervention reviews to ensure it timely starts cases, and 100-day case reviews to ensure it continues to timely work cases. Appeals should also experiment with taxpayer contacts, especially in campuses, to determine whether the number of outbound calls increases taxpayer responsiveness.

Dissatisfaction with Appeals' fairness and its failure to respond or consider information erodes relationships with taxpayers and their representatives.

> "I think in every case the Appeals officer who is handling it should contact the taxpayer or their representative personally. A phone call, not just a letter."

From October 2005 through September 2008, customer satisfaction concerning fairness in resolving its cases and Appeals' consideration of information taxpayers presented fell nine and ten percent, respectively.[33] Appeals could correct these problems by increasing its contact with taxpayers, whether face-to-face or by telephone. In particular, Appeals' contacts help unrepresented taxpayers understand documentation requirements or legal positions. Appeals also could improve relations through more outreach. The National Taxpayer Advocate is pleased that Appeals has planned at least one outreach event in each Appeals area entitled, "Meet Appeals."[34] More such events would help taxpayers.

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30 American Bar Association Section of Taxation, *Survey Report on Independence of IRS Appeals* 38 (Aug. 11, 2007).

31 TIGTA, Ref. No. 2007-10-071, *The Office of Appeals Needs to Improve the Monitoring of Its Campus Operations Quality* 13 (May 10, 2007).

32 IRS, *Appeals Quality Measurement System Appeals (All Areas) Results Report FY 2008* 3 (Dec. 4, 2008).

33 IRS, *Appeals Customer Satisfaction Survey National Report FY 2008 Results* 27-28 (Feb. 2009).

34 Appeals, *Business Performance Review* 28 (Feb. 19, 2009).

Upgrades to Appeals' systems are necessary to track customer satisfaction and quality performance of its campus and field operations and respective workstreams.

Appeals uses several tools to assess the quality of its services, including customer satisfaction surveys, operational reviews, and the Appeals Quality Measurement System (AQMS). Appeals developed the AQMS to deliver case quality data and to measure the success of its strategies.[35] The AQMS provides overall case quality data from the review of a statistically valid sample of closed cases. According to TIGTA, however, Appeals' AQMS does not produce a statistically valid independent sample of campus and field operations to find specific problems within each operation or by workstream.[36] Appeals responded that the AQMS uses case information from many sources to continually assess operations, identify opportunities for improvement, and track the impact of its efforts. While Appeals agreed that it would like more detailed data, its analysis revealed it would need three times as many resources (*i.e.*, additional staff at a cost of $2 million) to produce a statistically valid sample at both the campus and workstream levels. Appeals indicated it would seek less expensive alternatives because additional staffing for quality measurement would take resources away from front-line operations.[37]

TIGTA also found that Appeals campus personnel did not always make correct determinations. In 31 percent of closed penalty cases sampled, the hearing officer inadequately researched the taxpayer's history, incorrectly interpreted law or policies, or lacked proper training.[38] These actions could cause increased burden and denial of rights and entitlements for taxpayers, and loss of revenue for the government. Moreover, these conditions would not have been reported to Appeals since AQMS results are not reported or sampled independently by workstream.[39]

The Appeals Centralized Database System (ACDS) is a web-based system used to control and track cases throughout the appeal process. Appeals also generates management statistics and reports from the ACDS.[40] In comparing the ACDS data to documentation in closed Appeals case files, the Government Accountability Office found significant errors related to data that would be used for typical case feedback, noting that the highest error rates were related to the results of an appeal, *e.g.*, adjustments to tax and penalty amounts and case closing-code fields. GAO found that Appeals has not addressed all of its data accuracy issues, and would likely experience these issues until it improves internal controls over the data entered into the ACDS. This is critical as Appeals needs accurate information to

35 Appeals, *Strategic Plan FY 2006-2009* 4; TIGTA, Ref. No. 2007-10-071, *The Office of Appeals Needs to Improve the Monitoring of Its Campus Operations Quality* 2 (May 10, 2007).

36 TIGTA, Ref. No. 2007-10-071, *The Office of Appeals Needs to Improve the Monitoring of Its Campus Operations Quality* 2 (May 10, 2007).

37 *Id.* at 27.

38 Appeals, *Strategic Plan FY 2006-2009* 4; TIGTA, Ref. No. 2007-10-071, *The Office of Appeals Needs to Improve the Monitoring of Its Campus Operations Quality* 8 (May 10, 2007).

39 *Id.* at 20-21.

40 IRM 8.1.3.2.3 (Oct. 23, 2007); Government Accountability Office (GAO), GAO-06-396 *Opportunities to Improve Compliance Decisions and Service to Taxpayers through Enhancements to Appeals' Feedback Project* 3-4, 28 (Mar. 2006).

ascertain whether to change its own or IRS policies, procedures, or practices based on those analyses.[41]

Appeals responded to GAO's report by creating a cross-functional feedback review team. This team analyzes policies, processes, and systems to identify and remove barriers to timely and efficient services. It incorporates AQMS results and Appeals' Advisory Board meetings to exchange information.[42] This "Feedback Loop" produced the Premature Referral and Acceptance (PREA) Team, a partnership with the Examination functions in the Small Business/Self-Employed (SB/SE) and Wage and Investment (W&I) operating divisions to prevent undeveloped cases from reaching Appeals. The PREA team reviewed docketed examination cases where the taxpayer provided Appeals with documents, information, arguments or issues not previously reviewed by the IRS examiner. Its review revealed that Appeals' existing IRM guidance was sufficient, but that neither SB/SE nor W&I had any guidance concerning these premature referrals.[43] The PREA team is also conducting a review of the current level of examination assistance needed in Appeals. The National Taxpayer Advocate is pleased that Appeals is trying to implement change with a cross-functional group. This "Feedback Loop" would be greatly improved by the systematic gathering and monitoring of accurate data.

Appeals fails to analyze data and report on whether taxpayers are receiving the hearings they request. Appeals does not analyze data on case transfers (and reasons therefor), alternative hearing locations, and defaults (no shows) on campus and field cases. This information is crucial for evaluating taxpayer service and Appeals' effectiveness in educating taxpayers about the appeals process in its field and campus offices, and determining whether taxpayers are receiving requested hearings.

Taxpayers who seek assistance from Appeals may not have access to local hearings and local Appeals personnel (*i.e.*, through correspondence, by telephone, or face-to-face).

Campus specialization enabled Appeals to realize reductions in cycle time, by working "less complex" cases at the campuses. However, it did not come without a toll on Appeals' customers, most notably the loss of local knowledge of conditions in the taxpayers' geographic locations that may impact business practices, collection matters, expenses, refinancing, valuations, etc.[44] Appeals' policy calls for the transfer of a case to the field office

41 GAO, GAO-06-396, *Opportunities to Improve Compliance Decisions and Service to Taxpayers through Enhancements to Appeals' Feedback Project* 19-22 (Mar. 2006).

42 *See* Appeals, *SPMA Analyst Program Assignments* (June 15, 2009), which lists Appeals Advisory Boards: Collection Advisory Board; Counsel Advisory Board; LMSB Advisory Board; Oversight Board; SB/SE Advisory Board; W&I Advisory Board; and TAS Advisory Board. *See also* Appeals, *Strategic Plan FY 2008-2012* 4, 8; Appeals, *Business Performance Review* 17 (Feb. 19, 2009).

43 *See* IRM 8.1.1.5.1 (Oct. 23, 2007); Appeals, *Business Performance Review* 13-14 (Feb. 19, 2009).

44 The National Taxpayer Advocate addressed concerns with campus specialization in prior Annual Reports to Congress. *See* National Taxpayer Advocate 2008 Annual Report to Congress 264-66; National Taxpayer Advocate 2006 Annual Report to Congress 130; National Taxpayer Advocate 2005 Annual Report to Congress 136; National Taxpayer Advocate 2004 Annual Report to Congress 264, 311.

closest to the taxpayer's location for face-to-face hearings.[45] However, Appeals promotes resolving issues by telephone or correspondence, contending that these options are the preferred choice of taxpayers.[46] The National Taxpayer Advocate supports teleconferencing and correspondence with taxpayers who prefer them. This type of contact can occur whether the appeals officer is remote or local. However, the National Taxpayer Advocate believes taxpayers should be able to have hearings with local appeals or settlement officers, by telephone, correspondence, or face-to-face, when local economic conditions or issues are involved, without having to travel outside their local areas.[47]

Section 3465 (b) of RRA 98 states, "The Commissioner of Internal Revenue shall ensure that an appeals officer is regularly available within each state."[48] However, nine states do not have appeals officers or settlement officers. The following table lists these states, along with the number of resident appeals and settlement officers, and the designated Appeals office servicing those states at September 20, 2003 (pre-CSI) and September 26, 2009 (post CSI).

TABLE 1.4.2, States with No Appeals Officers or Settlement Officers, at September 30, 2003 (Pre-CSI) Staffing and September 26, 2009 (Post-CSI) Staffing[49]

State	September 30, 2003		September 26, 2009	
	Appeals Officers	Settlement Officers	Appeals Officers	Settlement Officers
Alaska	2	0	0	0
Arkansas	1	1	0	0
Idaho	0	0	0	0
Kansas	1	0	0	0
Montana	1	0	0	0
North Dakota	1	0	0	0
Rhode Island	0	0	0	0
Vermont	1	0	0	0
Wyoming	0	0	0	0

The National Taxpayer Advocate is concerned that taxpayers in states such as Arkansas, which have no appeals officers or settlement officers, may need to travel far to obtain face-to-face hearings. In the alternative, they may opt to avoid the frustration and merely settle for a telephone hearing in order to save time and expense, even though that decision

45 *See* IRM 8.4.2.3 (Oct. 30, 2007); IRM 8.22.2.2.6.4 (Mar. 11, 2009); IRM 8.23.2.2.1 (Aug. 28, 2009). Face-to-face conferences are not offered for taxpayers who only raise frivolous or groundless issues. IRM 8.6.1.4 (May 5, 2009).

46 Appeals, *Strategic Plan FY 2008 – 2013* 4.

47 National Taxpayer Advocate 2008 Annual Report to Congress 264-67.

48 RRA 98 § 3465(b), Pub. L. No. 105-206 (IRC §7123); GAO, GAO/GGD-00-85, *IRS' Implementation of the Restructuring Act's Taxpayer Protection and Rights Provisions* 17 (Apr. 2000); RRA 98 requires that the IRS assigns an appeals officer to each state and considers videoconferencing in rural and remote areas.

49 IRS, Human Resources Reporting Center, *Organizational Location Reports* (Sept. 26, 2009).

may be against their interest. Appeals claims it permits its appeals officers to hold conferences on dates and in locations reasonably convenient to taxpayers and representatives. Managers may approve this "circuit-riding" by appeals officers when feasible and necessary to provide a convenient conference opportunity.[50] However, the guidance does not address taxpayers with special needs, such as low income taxpayers, taxpayers who speak English as a second language, and those with disabilities. Further, Appeals fails to track these requests or whether alternative locations are used.[51]

Appeals should observe the direction of RRA 98 by redeploying its staffing and placing at least one appeals officer and one settlement officer in each state. In states where there are remote areas and travel is difficult, Appeals should pilot closed circuit videoconferencing, so that all taxpayers can avail themselves of a local hearing.

The National Taxpayer Advocate is concerned by the recent trend in Appeals hiring practices between campus and field offices. In FY 2009, Appeals began an ambitious initiative to hire up to 400 new employees.[52] From FY 2007 to FY 2008, the number of campus personnel increased by over six percent while the number of field personnel decreased.[53] From FY 2008 to FY 2009, the disparity continued, with a 34 percent increase in campus personnel, and an increase of only six percent in field personnel.[54] By this trend, it appears that Appeals intends to increase both the number of campus employees and campus caseloads.

Appeals reports that the field conducted an in-depth analysis of Appeals workload by case type, complexity, and geographic distribution, in conjunction with the Appeals Strategic Planning/Measures and Analysis group. The analysis revealed that over 60 percent of Appeals' customers are better served through its campuses.[55] This analysis is unsupported by Appeals' customer satisfaction data. Thus, it should not be used as a basis in its FY 2009 program letter to support expanding the use of additional campus teams.[56] The National Taxpayer Advocate urges Appeals to weigh taxpayer preferences carefully in making local hearings available to those who prefer them, and proposes that Appeals conduct additional

50 IRM 8.6.1.3.1 (Nov. 6, 2007).

51 *See* National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 107 (70 percent of respondents to TAS audit barrier study preferred to communicate with the IRS in a manner other than correspondence when trying to resolve an Earned Income Tax Credit audit; 23 percent of those respondents preferred to communicate in person).

52 Appeals, *Business Performance Review* 28 (May 15, 2009).

53 IRS, Human Resources Reporting Center, *Organizational Location Reports* (Sept. 27, 2008); IRS, Human Resources Reporting Center, *Organizational Location Reports* (Sept. 29, 2007).

54 IRS, Human Resources Reporting Center, *Organizational Location Reports* (Sept. 26, 2009); IRS, Human Resources Reporting Center, *Organizational Location Reports* (Sept. 27, 2008).

55 Appeals, *Business Performance Review* 24 (May 15, 2009); Appeals, *Business Performance Review* 15 (Feb. 19, 2009).

56 IRS, *Appeals Memorandum for All Employees, Fiscal Year 2009 Organizational Priorities* (Nov. 24, 2008). The program letter states Appeals shall "allocate resources from a data driven approach, while expanding the use of alternative taxpayer treatment by supporting the standup of additional campus teams that will work campus-appropriate cases."

research and extensive taxpayer surveys, similar to the Taxpayer Assistance Blueprint (TAB), to create a strategy that works for Appeals and taxpayers alike.[57]

CONCLUSION

The National Taxpayer Advocate understands the importance of a fully functioning Appeals office for taxpayer service. Appeals should understand that it is not like any other division of the IRS. Taxpayers who have an opportunity to redress their concerns with an impartial and knowledgeable appeals officer will likely believe they received fair treatment. Taxpayers look to Appeals for its ability to protect their rights and foster their voluntary compliance.

RECOMMENDATIONS

While Appeals clearly needs additional resources to accomplish its mission, in conclusion, the National Taxpayer Advocate offers these preliminary recommendations:

1. Allocate resources and revise procedural manuals to require that Appeals account resolution specialists, or any other employees responsible for a case, contact the taxpayer routinely while his or her appeal is pending;
2. Revise all uniform acknowledgment letters to include information on alternative representation, such as LITCs and TAS;
3. Revamp databases and quality measurement to track and compile data in all categories, including transfers, defaults and no response cases, and workstreams between campus and field offices, and between represented and unrepresented taxpayers;
4. Conduct a TAB-like survey to determine allocation of resources between campus and field Appeals by gathering data concerning the differences of these offices as well as information from taxpayers, representatives, and other stakeholders concerning their satisfaction, needs, preferences and experiences with Appeals;
5. Increase local office staffing so that at least one appeals officer and one settlement officer sit in each office;
6. Implement a pilot to hold closed circuit videoconferencing between remote areas and Appeals offices; and
7. Require management to conduct early intervention and 100-day case reviews.

IRS COMMENTS

The IRS is proud of the work accomplished by Appeals in FY 2009, particularly given that the organization was faced with a record growth in receipts that year. Since FY 2006, Appeals' case receipts have grown by nearly 29 percent, setting new records every year.

[57] *See* National Taxpayer Advocate 2006 Annual Report to Congress 284. In some cases, taxpayers believe their cases will be better understood by an appeals officer in the community, particularly when the underlying examination was conducted by a remote correspondence unit.

However, Appeals also has managed to set new records for case closures each year during this period, with performance in key metrics such as cycle time and average hours per case decreasing. Appeals has a difficult job, made more challenging by the ever-growing receipts, yet the vast majority of taxpayers who interact with Appeals are satisfied with both our professionalism and the degree of respect demonstrated by our workforce. Customer satisfaction has risen overall from 53 percent to 65 percent between FY 2003 and FY 2008, the last year for which we have results, and now stands at the second highest level since inception of the survey.

Similarly, Appeals' employee satisfaction is on the rise and is currently at an all-time high. Appeals employees are committed to its mission: *to resolve tax controversies, without litigation, on a basis which is fair and impartial to both the Government and the taxpayer in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service*. In carrying out this mission, Appeals advocates for neither side in the dispute. The IRS believes strongly that this provides the best service to all taxpayers.

As with all IRS organizations, Appeals' ability to meet future challenges is directly linked to the strength of its employees. Appeals continues to maintain a strong, well-educated workforce dedicated to getting to the right answer. With organization-wide Continuing Professional Education conducted throughout FY 2009, Appeals worked to further build upon the knowledge and expertise of the case handling staff as well as personnel from the procedure, policy, guidance, and support groups. Moreover, a series of organizational enhancements made throughout FY 2009 have been designed to streamline work processes and make case work more efficient and effective for both Appeals and the taxpayers it serves. The IRS is confident in Appeals' ability to meet the challenges of the future and will continue to engage in activities designed to help the organization continue to advance.

There has been substantial progress in one such initiative involving the campus operations. In FY 2005, TIGTA identified areas for improvement during its review of determinations made in certain cases worked in campus sites during their first year of operation. The IRS has since clarified abatement policies, reinforced proper case research methods, enhanced the application of penalty criteria, and strengthened internal procedures in these areas. TIGTA is currently conducting a follow-up audit of our campus operations, and although the report has not been issued, TIGTA has noted an improvement in Appeals' determinations.

Appeals has also enhanced its ability to monitor the quality of case work in all operations, wherever located. This includes being able to review a statistically valid sample for each of the six campus locations. In addition, the quality management function routinely analyzes data regarding different types of cases closed by field and campus employees, and provides feedback to the Appeals workforce for ways to improve.

Taxpayers, other stakeholders, and Appeals personnel benefit greatly from exchanging ideas and information outside of the traditional case process. In FY 2009, Appeals

participated in over 150 outreach events geared towards audiences ranging from tax practitioners to high school students. Participation in the IRS Nationwide Tax Forums was a particular success. The cities chosen to host the IRS's largest outreach events included Las Vegas, San Diego, Orlando, New York, Dallas, and Atlanta, and the number of registered tax practitioners topped 14,000. Appeals' presentations during the Orlando Forum were filmed for web streaming on both IRS.gov and the IRS intranet, thus enabling it to reach even more stakeholders.

Appeals will continue to welcome all input from our respective stakeholders, including the National Taxpayer Advocate, as it continues to advance the dispute resolution process offered to taxpayers.

In her report, the National Taxpayer Advocate makes seven recommendations. We are taking or have taken the following actions with respect to these issues:

Appeals has made significant progress in quality measurement tracking. It has a statistically valid sample for all seven Field Areas, all six campuses, Appeals Team Case Leaders (ATCL) operations and Technical Guidance operations, with an abundance of data and reports for each. Data is retrievable via the Appeals Centralized Database System by case type and is used to help identify training issues and areas in need of improvement. Appeals will continue to review this issue and look for additional improvements.

Appeals holds hearings and conferences by phone or in person on cases involving a wide variety of issues, many of which are technically complex. Appeals works with taxpayers and their representatives to schedule these meetings on dates and at locations convenient to them. Taxpayers are never required to travel out of state for face-to-face meetings unless they prefer meeting in an alternate location as a matter of convenience. Appeals is committed to having an Appeals Officer or a Settlement Officer with the specialized technical expertise necessary to address the case at hand available for face-to-face meetings in every state, whether or not it hosts a permanent Appeals office. For nine states, this means employees circuit ride at least quarterly to meet the needs of each and every taxpayer.

Appeals will continue to consider new technology, such as closed circuit videoconferencing to remote areas, as permitted by funding, and IRS security and disclosure rules. For example, the ATCL operation is currently participating with the Large and Mid-Sized Business Unit in a pilot program to utilize email in working with taxpayers.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate acknowledges that Appeals provides a vital service to taxpayers and the government, and applauds Appeals for receiving high ratings for professionalism and the degree of respect shown to taxpayers. We are pleased that Appeals is concerned about improving the timeliness of its case closures. However, the National Taxpayer Advocate is troubled that taxpayers' overall satisfaction with Appeals is low, has remained stagnant, and has decreased for unrepresented taxpayers since FY 2006.[58] Further, customer satisfaction ratings for consideration of information presented by taxpayers and fairness in resolving taxpayers' cases have decreased in the same period. The National Taxpayer Advocate is concerned that such a low level of customer satisfaction, if not corrected soon, will erode taxpayer confidence in Appeals. This in turn may undermine voluntary compliance.

The National Taxpayer Advocate agrees that having a well-educated workforce dedicated to Appeals' mission is essential to effective taxpayer service. We commend Appeals for streamlining work processes and improving efficiency. However, the National Taxpayer Advocate is concerned that improving the speed of these processes in a campus environment will not necessarily improve taxpayer service. While taxpayer satisfaction with the timeliness of Appeals cases has historically been low, further reductions in case time may result in poor handling of cases (especially for unrepresented taxpayers), superficial analyses, and unfair decisions.

The National Taxpayer Advocate is encouraged by Appeals' reported progress in addressing areas for improvement identified by TIGTA, concerning the application of penalty criteria, penalty abatement policies, case procedures, and research methods. However, AQMS reports reveal extended delays and mishandling of cases, most notably at Appeals' campus operations.[59] We urge Appeals to strengthen the managerial oversight of case activity and processing needed to improve case quality, and lessen the amount of downstream rework that creates taxpayer uncertainty.

The National Taxpayer Advocate is pleased that Appeals has improved its ability to measure, monitor, and track the quality of its casework in all operations, and can now review a statistically valid sample of cases for each of its seven field areas and six campuses. Still, despite Appeals' ongoing efforts to cope with systems limitations and chronic budgetary constraints, the National Taxpayer Advocate believes Appeals may need critical systems upgrades and without them may be unable to accurately assess performance. We urge Appeals to give priority to modifications that will improve customer satisfaction. Further,

58 IRS, *Appeals Customer Satisfaction Survey, National Report FY 2008* 12, 92 (Feb. 2009); *National Report FY 2007* 9, 90 (Mar. 2008); *National Report FY 2007* 8 77 (May 2007); FY 2009 customer satisfaction survey results were not available at the time of publication.

59 American Bar Association Section of Taxation, *Survey Report on Independence of IRS Appeals* 38 (Aug. 11, 2007); TIGTA, Ref. No. 2007-10-071, *The Office of Appeals Needs to Improve the Monitoring of Its Campus Operations Quality* 13 (May 10, 2007); IRS, *Appeals Quality Measurement System Appeals (All Areas) Results Report FY 2008* 3 (Dec. 4, 2008).

Appeals should compile, analyze, and report data by workstream, and by issue, including requests for case transfers, alternative hearing locations, and defaults (no shows) on campus and field cases.

The National Taxpayer Advocate is concerned that Appeals is hiring more campus employees regardless of customer satisfaction and case quality ratings. We urge Appeals to balance the number of employees assigned to campus and field locations based on an objective workload study that considers taxpayer needs and preferences, and is supported by customer satisfaction and case quality data. Such an approach should be similar to the one used in the Taxpayer Assistance Blueprint. We also urge Appeals to provide comprehensive training to employees on collection alternatives and debt resolution, focusing not only on IRS rules and requirements, but also from a taxpayer's perspective. While the National Taxpayer Advocate has never questioned the dedication of Appeals' employees, and their commitment to carrying out Appeals' vital role in tax administration, she believes Appeals' current deployment may be hindering its employees' ability to satisfy their customers.

Nine years ago, the GAO reported that the IRS was actively assigning Appeals officers to each state and considering video conferencing in rural or remote areas to implement § 3465(b) of RRA 98.[60] However, Appeals has yet to adopt either requirement. Appeals contends that taxpayers are never required to travel out of state for a face-to-face hearing (*i.e.*, unless they prefer meeting in another state as a matter of convenience). Appeals further contends that it satisfies taxpayers' needs by using designated employees who "circuit ride" the nine states that lack a resident appeals officer or settlement officer. The National Taxpayer Advocate disagrees that "circuit riding" offers sufficient taxpayer access to Appeals to satisfy the needs of "each and every" taxpayer in these states. Appeals would better serve taxpayers if it had knowledgeable employees in every state. We urge Appeals to consider the needs of low income taxpayers, those for whom English is a second language, and those with disabilities, by observing the direction of RRA 98. The National Taxpayer Advocate encourages Appeals to redeploy its staffing to local area offices so that it has at least one appeals officer and settlement officer permanently posted in each state. Moreover, Appeals should test videoconferencing where feasible to help bridge the geographic divide that now exists in remote areas.

We are disappointed that Appeals has not agreed to modify its uniform acknowledgement letters to include information on alternative representation, such as LITCs and TAS. Taxpayers' representatives have an important role in educating taxpayers about the appeals process, as do Appeals officers. The National Taxpayer Advocate insists that Appeals take this next step in working to improve customer satisfaction by revising these letters.

60 RRA 98 § 3465(b), Pub. L. No. 105-206 (IRC §7123); GAO, GAO/GGD-00-85, *IRS' Implementation of the Restructuring Act's Taxpayer Protection and Rights Provisions* 17 (Apr. 2000). RRA 98 requires that the IRS assigns an appeals officer to each state and considers videoconferencing in rural and remote areas.

The National Taxpayer Advocate looks forward to working collaboratively with Appeals in identifying and overcoming challenges that create unnecessary taxpayer burden and adversely affect taxpayer rights and entitlements.

Recommendations

The National Taxpayer Advocate recommends that the IRS take the following specific actions:

1. Allocate resources and revise procedural manuals to require that Appeals account resolution specialists, or any other employees responsible for a case, contact the taxpayer routinely while his or her appeal is pending;
2. Revise all uniform acknowledgment letters to include information on alternative representation, such as LITCs and TAS;
3. Revamp databases and quality measurement to track and compile data in all categories, including transfers, defaults and no response cases, and workstreams between campus and field offices, and between represented and unrepresented taxpayers;
4. Conduct a TAB-like survey to determine allocation of resources between campus and field Appeals by gathering data concerning the differences of these offices; as well as information from taxpayers, representatives, and other stakeholders concerning their satisfaction, needs, preferences and experiences with Appeals;
5. Increase local office staffing so that at least one appeals officer and one settlement officer sit in each office;
6. Implement a pilot to hold closed circuit videoconferencing between remote areas and Appeals offices; and
7. Require management to conduct non-evaluative early intervention and 100-day case reviews.

MSP #5

The IRS Lacks a Servicewide e-Services Strategy

RESPONSIBLE OFFICIALS

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DEFINITION OF PROBLEM

While the IRS strives to "provide America's taxpayers with top-quality service,"[1] it has a long way to go to meet the technological preferences of taxpayers and practitioners in their interactions with the agency. The IRS has developed a significant number of online tools to assist taxpayers and practitioners in understanding and meeting their tax responsibilities.[2] However, there appears to be no overarching strategy for the development, implementation, and improvement of electronic services. In addition, the IRS needs to regularly monitor taxpayers' and practitioners' preferences for service delivery to ascertain how needs and expectations change as technology advances.

The IRS should evaluate the experiences of private industry and other domestic and international government agencies to identify the type of services to offer, as well as the obstacles and successes involved in developing and implementing them. Finally, given that the use of technology to interact with taxpayers and practitioners impacts every organization within the IRS, the IRS should build upon the findings of the Taxpayer Assistance Blueprint (TAB) Strategic Plan and the Advancing e-File Study and develop a servicewide team to create and implement an electronic services strategy. Such a strategy should address online account management, a direct filing option, 2-D barcode technology, and quick refund turnaround times.[3]

ANALYSIS OF PROBLEM

Background

The IRS has acknowledged that a major trend affecting tax administration is the "explosion of electronic data, online interactions and related security risks." In fact, the IRS has stated:

1 IRS Mission Statement, *IRS Strategic Plan 2009-2013*.

2 A list of current IRS online tools is available at: http://www.irs.gov/efile/article/0,,id=151880,00.html?portlet=4.

3 TAB Strategic Plan and associated research reports, *available at* http://www.irs.gov/individuals/article/0,,id=156394,00.html; IRS, *Advancing e-file Study Phase 1 Report: Achieving the 80% E-file Goal Requires Partnering with Stakeholders on New Approaches to Motivate Paper Filers* (Sept. 30, 2008), *available at* http://www.irs.gov/pub/irs-utl/irs_advancing_e-file_study_phase_1_report_v1.3.pdf (last visited Aug. 25, 2009).

> Technologically savvy taxpayers are demanding that government institutions provide them the same level of electronic sophistication and online service that they receive from best-in-class private sector organizations. However, more people connecting through Information Technology (IT) systems makes it exponentially more difficult than it was a few years ago to safeguard data and systems. We must become more technologically sophisticated to meet increased taxpayer expectations and maintain data security – modernizing our systems, improving our training and continually enhancing our safeguards.[4]

In February 2008, the IRS Services Committee approved a pilot of the e-Council, a collaborative body consisting of the Office of Electronic Tax Administration and Refundable Credits (ETA), Modernization and Information Technology Services (MITS), and other business units (including the Taxpayer Advocate Service). The e-Council evaluates e-Services strategies and systems requirements.[5] Given the importance of the subject matter, it is imperative that the IRS (1) give the e-Council high priority status, (2) engage the right players on the team, (3) make certain that the group satisfies its mission to develop a comprehensive vision of electronic services, and (4) require the team to report regularly to the Services Committee.[6]

Researching Taxpayer Preferences

A crucial component of any e-strategy is to first understand the service needs and preferences of taxpayers to maximize compliance with the tax laws. The Taxpayer Assistance Blueprint team conducted extensive research on the needs, preferences, and behaviors of individual taxpayers.[7] Taxpayer preference data indicated that individual taxpayers generally prefer self-assisted services, such as those found on the IRS website, for transactional tasks such as retrieving a form or a publication. They preferred assisted services, such as those available through telephones or Taxpayer Assistance Centers (TACs), for more complex interactive tasks like responding to a notice. In addition, the telephone and Internet channels account for almost 85 percent of all taxpayer contacts with the IRS, especially post-filing services.[8] Given the data, the TAB envisioned an IRS that is an "interactive and fully integrated, online tax administration agency" with the capability "for any exchange or

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4 IRS, *Major Trends Affecting the IRS: 2009-2013.*

5 IRS, *Report to Congress: Progress on the Implementation of the Taxpayer Assistance Blueprint April 2007 to February 2008, available at* http://www.irs.gov/pub/irs-utl/tab_progress_report_to_congress_final_043008.pdf (last visited Aug. 18, 2009).

6 As recommended in the TAB, the IRS Commissioner chartered the IRS Services Committee as the governance body for IRS service investment decisions. The committee is responsible for overseeing, prioritizing and approving an integrated portfolio of IRS services.

7 The TAB only addressed individual taxpayers. The IRS needs to conduct a study similar to TAB for small business and self-employed taxpayers as well as exempt organizations. *See, e.g.*, Most Serious Problem: *Targeted Research and Increased Collaboration Are Needed to Meet the Needs of Tax-Exempt Organizations, infra*; National Taxpayer Advocate 2008 Annual Report to Congress 97, 105; IRS, *Report to Congress Progress on the Implementation of The Taxpayer Assistance Blueprint April 2007 to February 2008*, 46; National Taxpayer Advocate 2007 Annual Report to Congress viii, 37-38, 209.

8 IRS Publication 4579, *2007 Taxpayer Assistance Blueprint Phase* 2, Executive Summary 3-4 (Apr. 2007), *available at* http://www.irs.gov/pub/irs-utl/tab-2summary.pdf (last visited Aug. 20, 2009)

transaction that currently occurs face-to-face, over the phone, or in writing to be completed electronically."[9]

The TAB Phase 2 report also included the following recommendations:[10]

- Maximize the value of the IRS website to make it the first choice of taxpayers and partners for obtaining information and services (the TAB acknowledged that some taxpayers will never use the Internet for certain services);
- Develop a comprehensive strategy that includes implementation of usability labs interactively throughout the web development lifecycle;
- Continue to enhance the design of the website to make information easier to find and manage, simplifying the overall user experience;
- Conduct usability studies with a particular focus on individual taxpayer segments identified as likely to use or migrate to the electronic channel, and their use of self-assistance tools;
- Drive improvements to content design to maximize the ability of taxpayers and partners to receive requested information and services on the first try;
- Develop a much broader use of electronic interactions between taxpayers, practitioners, and the IRS by providing account management and the ability to resolve account issues securely over the Internet;
- Develop an authentication strategy that enables all users to perform account-related services by logging in to the website once; and
- Decrease the time burden of using multiple account-related online tools, while protecting taxpayer privacy.

Several other studies have also substantiated the need to develop a comprehensive e-services strategy. For example, the 2008 IRS Oversight Board Taxpayer Attitude Survey indicated that approximately 90 percent of individual taxpayers feel it is "very or somewhat important" that the IRS provides various assistance channels.[11] Moreover, IRS survey data show that approximately 45 percent of individual taxpayers contacted the IRS for assistance at least once during 2008 (up from 41 percent in 2006 and 39 percent in 2007), while approximately 34 percent of taxpayers visited the IRS website in 2008.[12] Thus, if a significant percentage of taxpayers are seeking assistance from the IRS directly, it is in the best

9 IRS Pub. 4579, *2007 Taxpayer Assistance Blueprint Phase* 2 (Apr. 2007). The TAB "provides the IRS a vehicle to ensure that taxpayer needs and preferences, including the need for face-to-face assistance, are not sacrificed to mere administrative convenience." In fact, one of the TAB's guiding principles was, "The IRS is committed to offering a portfolio of service options delivered across multiple channels, including face-to-face service." IRS Pub. 4579, *2007 Taxpayer Assistance Blueprint Phase* 2, 14, 67 (Apr. 2007).

10 Service Improvement Portfolio, IRS Publication 4579, *2007 Taxpayer Assistance Blueprint Phase 2*, 81 (Apr. 2007), *available at* http://www.irs.gov/pub/irs-pdf/p4579.pdf (last visited Aug. 20, 2009).

11 IRS Oversight Board, *Annual Report to Congress 2008* (Mar. 2009) at 25.

12 IRS Market Segment Survey for 2007and 2008; IRS Oversight Board, *Channel Preference Survey* (2006); IRS Oversight Board, *Annual Report to Congress 2008* (Mar. 2009) at 10.

interest of tax administration to study taxpayers' preferences for delivery of services, and make every effort to meet the needs of these taxpayers.

In light of the reports discussed above, it is clear that the IRS has a significant yet achievable amount of work to do to provide optimal electronic services to taxpayers. In addition, once the IRS implements online programs under an e-strategy, the IRS needs to regularly monitor taxpayer preferences and update its service delivery channels to accommodate taxpayers' needs. Such an investment in electronic services will serve the best interests of tax administration. Taxpayers and practitioners will likely increase compliance if they can interact with the IRS through a preferred channel of communication.

Learn from the Experience of Other Entities

The IRS should not develop an e-strategy in a vacuum. An important component of any e-strategy is to research the electronic services provided by other governmental and private entities. This would entail a review of online services, as well as a comprehensive evaluation of the obstacles, usage, and impact on "customer" behavior.

In fact, the Forum on Tax Administration of the Organisation for Economic Co-Operation and Development (OECD) surveyed eight member countries in 2005 to determine strategies for improving the take up rates of electronic services. The study revealed the following:[13]

- The achievement of a relatively high "take-up" or use of electronic services is typically accomplished through a multi-faceted set of strategies to promote usage by taxpayers;
- Information campaigns using a variety of channels are an essential component of revenue bodies' strategies;
- The use of incentives (*e.g.*, faster tax refunds and extended filing periods) appears to play a significant role in encouraging a good take-up rate, particularly concerning the personal income tax;
- Tax professionals who prepare a fair proportion of tax returns are critical stakeholders in effective electronic filing systems in many countries, and should be consulted widely and regularly on the development and operation of such systems;
- Mandatory electronic filing arrangements typically targeted larger businesses and took a less rigid approach initially; and
- Short of imposing mandatory requirements, which may present their own problems, there are no "silver bullets" for rapid success and good outcomes; a considerable investment of time, money, and staff is inevitably required over a fair period of time to achieve a good level of success.

[13] Forum on Tax Administration, Organisation for Economic Co-Operation and Development, *Strategies for Improving the Take up Rates of Electronic Services* (Mar. 2006); Forum on Tax Administration, Organisation for Economic Co-Operation and Development, *Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series 123* (Feb. 2007).

Particularly noteworthy e-services provided by foreign jurisdictions include the following:

- **Australian Taxation Office (ATO):** The ATO offers various electronic filing (e-tax), payment, and other online tools such as calculators.[14]
- **Canada Revenue Agency:** In addition to electronic filing and payment options, the Canada Revenue Agency provides "My Account" and "My Business Account," which are online account management tools for individual and business taxpayers. These tools even allow taxpayers to set up payment plans and dispute assessments and determinations online.[15]
- **Swedish Tax Agency and Enforcement Authority:** Sweden has various online tools to assist taxpayers, including pre-populated returns (income statements) and the ability to e-file income tax returns, Value Added Tax (VAT) returns, and social security contributions. Interestingly, the Tax Agency rents out space owned by other government functions in rural underserved areas to provide "satellite offices" with the capability to conduct video-conferencing services, scanning, and other digitizing functions to deliver, in an interactive manner, all service and compliance functions currently available to taxpayers in a face-to-face setting.[16]
- **United Kingdom's HM Revenue and Customs (HMRC):** HMRC's online services allow taxpayers to access real time accounts and amend information such as contact details; check eligibility and submit claims for benefits; and submit returns and declarations, and pay electronically.[17]

In addition to studying the experiences of other tax authorities, the IRS should review electronic services provided by federal agencies unrelated to tax administration. For example, the Social Security Administration provides many online services for individuals, businesses, and governments. Individuals can apply for benefits, manage accounts, and determine future benefits online.[18] In addition, the Department of Education provides an online Free Application for Financial Student Aid.[19]

Finally, the TAB recommended that the IRS develop service delivery channels similar in nature to those offered by many large financial institutions.[20] Many financial institutions have been offering online banking services to their customers for years. An increasing percentage of taxpayers are accustomed to conducting financial account transactions online with their banks and will likely prefer to interact with the IRS in a similar manner for

14 For more information, see http://www.ato.gov.au/ (last visited Apr. 22, 2009).

15 For more information, see http://www.cra-arc.gc.ca/esrvc-srvce/tx/ndvdls/myccnt/hlp-eng.html#mao.a1-1 (last visited Apr. 22, 2009).

16 National Taxpayer Advocate Meetings with Swedish Tax Agency and Swedish Enforcement Authority (Stockholm, Sweden May 25-29, 2009).

17 HMRC, *About Online Services*, http://www.hmrc.gov.uk/online/index.htm (last visited Apr. 22, 2009).

18 *See* http://www.ssa.gov/onlineservices/ (last visited Apr. 23, 2009).

19 For more information, see http://www.fafsa.ed.gov/ (last visited Sept. 1, 2009).

20 IRS Pub. 4579, *2007 Taxpayer Assistance Blueprint Phase 2* (Apr. 2007), Service Improvement Portfolio.

account transactions.[21] In addition, financial institutions face the same type of data protection issues facing the IRS.

Obstacles to Developing and Implementing e-Service Applications

The IRS faces several obstacles in developing a new e-services application: e-authentication, resources, and portals. Any comprehensive e-services strategy will need to address each of these areas.

E-Authentication

E-authentication is a significant challenge for the IRS, which does not have a servicewide e-authentication strategy and faces this issue every time it plans to develop a new online application with the potential to include sensitive taxpayer information. The TAB report noted the importance of an e-authentication strategy to enable users to perform account-related services securely online while at the same time safeguarding the taxpayer data available on such a web-based program.[22] Electronic services assist taxpayers to comply with their tax obligations, but any appearance of inappropriate disclosure of confidential tax information could undermine the system of voluntary compliance as well as reduce usage of the electronic service.

The IRS is now developing a servicewide e-authentication strategy. The National Taxpayer Advocate commends the IRS for undertaking such an important initiative. However, we encourage the IRS to focus not just on consistency of existing authentication procedures, but to also take a comprehensive look at the goals of e-authentication, including whether specific transactions require (or taxpayers demand) a higher level of authentication than others. Moreover, in designing its authentication process, the IRS should consider the e-literacy levels of the taxpayer populations most likely to use the specific services and design access accordingly.

Resources

The IRS is understandably constrained by limited resources. However, the IRS will likely recoup the costs of development and implementation of research-driven e-services applications through increased compliance and downstream savings. Congress should require the IRS to develop an accurate return-on-investment (ROI) model for its e-services strategy that incorporates downstream savings. This ROI model should provide Congress with significant assurances that its funding of the e-service strategy is well-spent.

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21 Service preferences differ between account and dispute transactions. Taxpayers have indicated that they still prefer assisted services for dispute transaction. IRS Pub. 4579, *2007 Taxpayer Assistance Blueprint Phase 2* (Apr. 2007).

22 IRS Pub. 4579, *2007 Taxpayer Assistance Blueprint Phase 2*, 83 (Apr. 2007), *available at* http://www.irs.gov/pub/irs-pdf/p4579.pdf (last visited Aug. 20, 2009).

Portal

Before the IRS can effectively implement any planned online services, it needs to improve its portals. In layman's terms, a portal is the gateway for all electronic submissions into the IRS. In FY 2006, the IRS recognized the need to upgrade its existing portal environment and initiated the New Portal Implementation Project. A significant amount of portal equipment was either near or at the end of its useful life expectancy. In addition, the IRS could not meet requirements for existing and planned projects needing portal support due to technical limitations of existing equipment.[23]

The IRS planned to complete the new portal environment by November 2008. However, the IRS cancelled the project in June 2008 before it was finished, citing two main reasons: (1) The lack of a comprehensive enterprise strategy that considered industry best practices or advancements in portal technology, and (2) Insufficient resources to cover the significant cost of replacing existing equipment. After canceling the project, the IRS hired a contractor to assist in developing an enterprise portal business strategy.[24]

The Treasury Inspector General for Tax Administration criticized the IRS for its delay in developing a portal strategy, noting the inefficiency in the delay. When the IRS needs to implement any new program requiring portal support, it increases the risk that new equipment may not integrate with any portal environment developed pursuant to a future portal strategy. Further, TIGTA found the IRS has no formal process to continuously identify and evaluate projects requiring portal support.[25]

Increase the Rate of e-File to Meet Demands of Taxpayers and Improve Tax Administration

Electronically filed returns have the lowest late filing, underpayment, and math error rates of all returns.[26] The IRS has strived to increase the e-file rate over the years and has achieved impressive success. In fact, during the 2009 filing season, almost 70 percent of individuals filed electronically, up from 61 percent the year before.[27]

Pursuant to a congressional directive, the ETA office is developing a comprehensive strategic plan to meet an 80 percent e-file goal. The directive states that this strategic plan should be developed in consultation with the National Taxpayer Advocate and other stakeholders.[28]

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23 Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2009-20-079, *Initial Efforts to Develop a New Web-based Portal Environment Were Not Successful* (May 19, 2009).

24 *Id.*

25 *Id.*

26 IRS Pub.4579, *2007 Taxpayer Assistance Blueprint Phase 2*, Executive Summary 3-4 (Apr. 2007), *available at* http://www.irs.gov/pub/irs-utl/tab2summary.pdf (lasted visited Aug. 20, 2009).

27 IRS News Release, *E-file Hits Record 90 Million; 30 Million Filed from Home Computers*, IR-2009-46 (Apr. 30, 2009).

28 Staff of H. Comm. on Appropriations, 110th Cong., H.R. 2764, Consolidated Appropriations Act, 2008, Pub. L. 110-161, Explanatory Statement at 871 (Comm. Print 2007); Staff of H. Comm. on Appropriations, 110th Cong., Financial Services and Government Appropriations Bill, 2008, at 28 (Comm. Print July 2007).

ETA has commissioned the MITRE Corporation to conduct the Advancing E-File Study, and we are pleased that it will determine or review the following items:

- The characteristics of paper and e-filers as well as potential barriers to e-file;
- The current third-party model of tax administration and current trends in state and foreign governments; and
- Potential strategies to increase the rate of e-filing or any other means to receive return information electronically. This will involve a review of direct filing with the IRS, 2-D barcoding, and Telefile.[29]

The IRS published a report on Phase 1 of the Advancing E-file Study in September 2008.[30] Phase 1 was a major effort to collect, analyze, and synthesize all substantial data on the IRS e-file program to help validate and launch future studies, research, and other activities to meet the congressionally set e-file goal of 80 percent. The resulting report identified 13 options, with no preference for any particular one, to lay the groundwork for future recommendations. The report presented three key findings:

- There is no quick fix or any single approach to convert paper filers to e-filing;
- The IRS must rely on partnerships with third parties, stakeholders, and Congress to advance e-file; and
- Even more important than innovative technology is the focus on filer behavior such as motivators, concerns, and relative positions on the technology adoption curve.

The IRS and MITRE are conducting Phase 2 of the Advancing E-File study, which is designed to build a comprehensive e-file strategy based on sound data and verifiable analysis. The National Taxpayer Advocate commends the IRS on this project, which represents an important first step in the government's fulfilling its core responsibility to taxpayers in a secure and straightforward fashion, without competing with the private sector. We encourage the IRS to work closely with the Office of the Taxpayer Advocate in this study.

Template and e-Filing Portal

The National Taxpayer Advocate has advocated for years for the IRS to place a basic, fill-in template on its website to permit taxpayers to prepare and file their own returns directly with the IRS for free.[31] This electronic tax return would be analogous to the paper environment, but would also incorporate the benefits of electronic technology. Specifically, the return should be a fill-in product, with math checking and number-transfer capability. The

[29] Staff of H. Comm. on Appropriations, 110th Cong., H.R. 2764, Consolidated Appropriations Act, 2008, Pub. L. 110-161, Explanatory Statement at 871 (Comm. Print 2007); Staff of H. Comm. on Appropriations, 110th Cong., Financial Services and Government Appropriations Bill, 2008, at 28 (Comm. Print July 2007).

[30] IRS, *Advancing E-file Study Phase 1 Report: Achieving the 80% E-file Goal Requires Partnering with Stakeholders on New Approaches to Motivate Paper Filers* (Sept. 30, 2008), *available at* http://www.irs.gov/pub/irs-utl/irs_advancing_e-file_study_phase_1_report_v1.3.pdf (last visited Aug. 25, 2009).

[31] *See, e.g.*, National Taxpayer Advocate 2004 Annual Report to Congress 471-77.

fill-in return should link to line-by-line IRS instructions for each form, as well as linking to publications referenced by the instructions. Any embedded worksheets in the instructions or publications would also be fillable, with math-checking and number-transfer capability. These capabilities will substantially reduce taxpayer error as well as the number of "math error" notices the IRS must issue each year.[32]

There is no reason why taxpayers should be required to pay transaction fees to file their returns electronically. A free template and direct filing portal would address some taxpayers' cost and security concerns and yield a greater number of e-filed tax returns. However, some taxpayers will not find a basic template sufficient and still choose to purchase a sophisticated software program.

During the 2009 filing season, the Free File program added a fillable forms option, Free File Fillable Tax Forms. However the program does not include the following essential features: (1) tax calculation; (2) transferring numbers between forms; (3) automatic basic math calculations; (4) links to IRS publications or specific instructions; and (5) the ability to download the return file to the taxpayer's own computer (the file is electronically stored on a commercial server). We commend this initial step, but the IRS still has much to accomplish before offering a user-friendly product.[33]

The Australian Taxation Office built e-tax, a direct filing program, completely in-house and officially launched the program in 1999. The resulting e-file (e-tax) rates are impressive. For the 2006-2007 tax year, approximately 15.8 percent of all individuals who lodged their returns did so through e-tax, compared to approximately 3.2 percent of U.S. taxpayers who self-prepared their returns using Free File for tax year 2007.[34] We hope the IRS can apply lessons learned from Australia's experience to its own e-file program, especially with regard to ATO's direct filing program, e-tax.[35]

Highly publicized phishing schemes confirm the need for the IRS to develop a free fill-in template and direct filing portal. For example, during the 2007 filing season, taxpayers became victims of identity theft after an Internet tax scam lured them into inputting confidential tax return information on sites masquerading as Free File sites. Potential Free

32 Congress contemplated the IRS developing a basic electronic template in the IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685 (1998). The RRA 98 conference report states that "the conferees also intend that the IRS should continue to offer and improve its Telefile program and make available a comparable program on the Internet." H.R. Rep. No. 105-599, at 235 (1998) (Conf. Rep.).

33 TIGTA also noted that "some taxpayers may not have benefited from this option because they were unaware of the Free File Fillable Tax Forms availability." TIGTA, 2009-40-142, *The 2009 Filing Season Was Successful Despite Significant Challenges Presented by the Passage of New Tax Legislation* 6 (Sept. 21, 2009).

34 ETA Marketing Database from the Compliance Date Warehouse (CDW) for Tax Year 2007 (Oct. 2009); ATO, Summary of Tax Statistics, *available at* http://www.ato.gov.au/content/downloads/00177078_2007CH1SUM.pdf (last visited on Sept. 1, 2009). TIGTA also noted a 36.7 decline in Free File usage from 2009 to 2008 in TIGTA, 2009-40-142, *The 2009 Filing Season Was Successful Despite Significant Challenges Presented by the Passage of New Tax Legislation* 5 (Sept. 21, 2009).

35 Further, only tax agents (the Australian equivalent to tax return preparers) use commercial software to prepare and file returns. ATO, Taxation Statistics 2006-7, *available at* http://www.ato.gov.au/corporate/content.asp?doc=/content/00177078.htm (last visited Sept. 1, 2009).

File users understandably fall victim to scams when the official IRS website itself directs taxpayers to a non-IRS commercial website for Free File.

All taxpayers should have the option to prepare and file their federal income tax returns on the IRS's own website. Although Free File is accessible through the official IRS website, not all taxpayers are eligible to use the program. Further, while the IRS has increasingly restricted Free File programs over the years, the IRS still exerts little control over the content of each one. As a consequence, each program has its own eligibility requirements, capabilities, and limitations, and the complexity confuses taxpayers.[36]

Better Approach to Address Paper Filers

Despite the IRS's best efforts, some paper filers will refuse to convert to e-file. The Advancing e-File study is addressing the best approach to these paper filers. The National Taxpayer Advocate believes it is imperative that the IRS develop 2-D barcode or substantially similar technology that would provide taxpayers and the IRS with many of the same benefits as electronic filing.[37] It is our understanding that the IRS has already incorporated 2-D technology into other functions.[38]

Taxpayer Demand for Refund Anticipation Loans

Taxpayer demand for costly commercial refund delivery products impacts tax administration.[39] While the IRS cannot directly regulate banking practices, it can influence the demand for such products by offering the following improved refund delivery options:[40]

- **Shorter Refund Turnaround Times.** Reduce the refund turnaround time to the shortest length possible. In conjunction with this initiative, it is imperative to publicize the actual range of refund delivery times.
- **Revenue Protection Indicator.** Include a Revenue Protection Indicator in the acknowledgement file, which would require the IRS to run additional compliance screens, such as the Dependent Database and Criminal Investigation screens, before releasing the

36 *See* IRS News Release, *Late Tax Scam Discovered; Free File Users Reminded to Use IRS.gov*, IR-2007-87 (Apr. 13, 2007). The IRS is also aware of several phishing schemes during the 2008 filing season. *See* IRS News Release, *IRS Warns of New E-Mail and Telephone Scams Using the IRS Name; Advance Payment Scams Starting*, IR-2008-11 (Jan. 30, 2008).

37 In a recent audit report, TIGTA also recommended that the IRS implement either character recognition or two-dimensional barcode technology to convert paper returns into electronic format. TIGTA, 2009-40-130, *Repeated Efforts to Modernize Paper Tax Return Processing Have Been Unsuccessful; However, Actions Can Be Taken to Increase Electronic Filing and Reduce Processing Costs* (Sept. 10, 2009).

38 To utilize 2-D barcode technology, a taxpayer or preparer prints a return prepared on software with a horizontal and vertical barcode containing tax return information. The IRS scans the return, captures the data, decodes it, and processes the return as if it had been sent electronically.

39 For a discussion of the impact such products have on tax administration, see Announcement 2008-7, *Guidance Regarding Marketing of Refund Anticipation Loans (RALs) and Certain Other Products in Connection with the Preparation of a Tax Return*, 2008-5 I.R.B. 379 (Feb. 4, 2008).

40 For a detailed discussion of the National Taxpayer Advocate's concerns regarding RALs, see National Taxpayer Advocate 2007 Objectives Report to Congress, Volume II (July 2006); National Taxpayer Advocate 2007 Annual Report to Congress 83-95 (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*); National Taxpayer Advocate 2005 Annual Report to Congress 162-79 (Most Serious Problem: *Refund Anticipation Loans: Oversight of the Industry, Cross-Collection Techniques, and Payment Alternatives*).

acknowledgement file. Although this method may delay the release of the acknowledgement file, it will reduce Refund Anticipation Loan (RAL) defaults. In addition to protecting taxpayers, the delay would reduce the desirability of RALs, because taxpayers would receive a direct deposit refund directly from the IRS in close to the same time period as they would receive a RAL.[41]

- **Stored Value Cards.** Create a Treasury stored value card (SVC) to enable unbanked taxpayers to take advantage of the benefits of direct depositing the refund without incurring the high transaction fees associated with commercial cards. In conjunction with this initiative, the IRS needs to publicize taxpayers' ability to use their existing SVCs to receive refunds in the 2010 filing season.[42]

Speed of Refund Processing

Most taxpayers interact with the IRS only once per year – to file their returns. Thus, the only "service" many taxpayers expect from the IRS is to receive their anticipated refund in the shortest time possible. The IRS owes it to taxpayers to minimize the turnaround time for legitimate refunds.

Pursuant to the Customer Account Data Engine (CADE) Program Strategy and Plan, the IRS is implementing successive releases of CADE, a modernized account information system that processes returns and will eventually replace the aging Individual Master File (IMF) system. Each successive release includes the processing of increasingly complex returns and accounts. While the IRS is running IMF and CADE concurrently, it is the ultimate goal to phase out IMF processing altogether, with the resulting single operating environment processing returns and updating accounts daily. The target date to have this system fully functional is filing season 2012, with downstream systems able to work off this single operating environment by filing season 2014.[43] We commend the IRS in focusing on this important matter and encourage the team to prioritize this project and keep the progress moving on target.

Online Account Access

The IRS needs to provide taxpayers with easy access to their accounts. As previously noted, the TAB recommended account management and the ability to resolve taxpayer account issues securely over the Internet.[44] With readily available online account access, taxpayers could monitor the status of their accounts and potentially take the unprompted initiative to

41 However, given the confidential nature of IRS screens, Criminal Investigation screens in particular, it is imperative that a Revenue Protection Indicator provide general information and not a road map for the unscrupulous to work the system. The National Taxpayer Advocate acknowledges that delaying the release of the acknowledgement file could potentially impact the rate of electronic filing. Thus, in order to address this concern, we propose that that the IRS run a pilot program to determine exactly how the inclusion of a Revenue Protection Indicator in the acknowledgement file will affect the individual e-file rate.

42 *See* National Taxpayer Advocate 2008 Annual Report to Congress 427-41.

43 Andy Buckler, IRS, Information Technology: *Customer Account Data Engine Program Strategy and Plan* (July 6, 2009).

44 IRS Pub. 4579, *2007 Taxpayer Assistance Blueprint Phase* 2 (Apr. 2007).

correct any perceived problems. If even a small percentage of taxpayers detect and address perceived account problems early in the process, both the taxpayers and the IRS could avoid more costly downstream enforcement efforts. Such ability to monitor accounts could also "demystify" the tax system for some taxpayers. Taxpayers may take more ownership in the system if they can see firsthand what happens after they interact with the agency through filings, payments, or other forms of communication. In addition, a taxpayer who receives a notice from the IRS could access the account online and potentially address the problem without having to hire a paid practitioner.

Of particular concern to the National Taxpayer Advocate is the Internet Customer Account Services (ICAS), also known as My IRS Account Application (MIRSA). This program was designed to provide taxpayers with direct access to account information and services through a secure suite of Internet applications, reducing the need for personal assistance from IRS Customer Service Representatives. The first phase of the implementation would have provided secure access to account and return transcript information. The second phase would have allowed taxpayers to submit electronic versions of the Change of Address, Disclosure Authorization, and Extension to File forms.[45]

The IRS has put this project on hold indefinitely.[46] The IRS gave several reasons for its action:

- The IRS needs to focus on its portal strategy before it implements such an application;
- The IRS also needs to develop an improved e-authentication strategy before undertaking a project with inherent data disclosure risks; and
- Research into a similar program in Canada has shown that the planned application would have a low take-up rate.[47]

While the above-provided reasons are certainly challenges in the development of MIRSA, they are by no means insurmountable. The TAB results point toward significant usage. While Canada's program may have experienced a low take-up rate, the IRS has not formally researched the demand for the program in the United States. The IRS should conduct this research to determine taxpayer preferences and demand for the service *while* it is developing its portal and e-authentication solutions. Once it implements these newly designed solutions, the IRS will be ready to implement the MIRSA program, which the IRS would design to meet the needs of taxpayers pursuant to the research.

45 *See* IRS Pub. 4579, *2007 Taxpayer Assistance Blueprint Phase 2*, 82 (Apr. 2007), *available at* http://www.irs.gov/pub/irs-pdf/p4579.pdf (last visited Aug. 20, 2009); IRS MIRA Privacy Impact Assessment at http://www.irs.gov/pub/irs-pia/mirsa-pia.pdf (last visited Apr. 22, 2009).

46 TIGTA, Ref. No. 2009-20-102, *Changing Strategies Led to the Termination of the My IRS Account Project* (Aug. 12, 2009).

47 *See*, IRS, *IMRS Q&A View* (IRS intranet site on file with TAS). David Williams, Director, IRS Electronic Tax Administration and Refundable Credits, Council for Electronic Revenue Communication Advancement 2009 Spring Meeting (Apr. 30, 2009).

On a related note, the e-Notices Workgroup of the IRS's Taxpayer Communications Taskgroup (TACT) is addressing the delivery of notices in electronic format.[48] As anticipated, a major obstacle is e-authentication to safeguard taxpayer data. While not as far-reaching as MIRSA, this project is a step in the right direction. As taxpayers increasingly conduct their financial affairs online, it is a natural progression to communicate with taxpayers through this medium.

CONCLUSION

To maximize tax compliance, the IRS needs a servicewide e-services strategy that would address the findings of TAB as well as the Advancing E-Study. However, the IRS needs to regularly monitor taxpayer preferences and evolve the strategy as necessary to suit the needs of taxpayers. It should include a direct filing option for taxpayers as well as 2-D barcoding or substantially similar technology. Taxpayers should also be able to interact with the IRS for account related issues online. Before the IRS can implement any of these electronic services, it is imperative to have solid e-authentication and portal strategies.

In development of such e-services strategy, the IRS needs to evaluate the experiences of other governmental and private entities. The IRS can look to these entities in designing a strategy as well as learning from the obstacles they faced.

In conclusion, the National Taxpayer Advocate offers these preliminary recommendations:

1. Develop a cross-functional e-services task force to determine the service delivery preferences and needs of taxpayers. Such a task force should review the analysis included in the TAB report, the Advancing E-file Study, and any future research studies as well as report to the IRS Services Committee;
2. Review services provided by other governmental authorities and private industry, identify services the IRS should offer in electronic format, and determine how to improve current services, which an emphasis on user-friendliness;
3. The IRS should prioritize the e-Council as well as evaluate its structure to determine if the all operating divisions and functions are adequately represented. The e-Council should not only determine which electronic services are necessary, but also weigh heavily the user-friendliness of each program under consideration;
4. Conduct a study similar to the TAB for both SB/SE taxpayers and exempt organizations to determine the service needs of these taxpayer populations, including their e-service needs and preferences;
5. Improve the filing template and develop a direct filing portal to provide a free government-sponsored method to electronically file returns;

[48] The Commissioner chartered TACT to study and improve the clarity, accuracy and effectiveness of written communications to taxpayers. The e-Notices workstream seeks to securely deliver taxpayer correspondence electronically through a service-wide, integrated, web-based system based upon customer preferences. TAS participates on the e-Notices team. http://irweb.irs.gov/AboutIRS/co/tact/default.aspx (last visited Apr. 22, 2009).

6. Implement 2-D barcoding or substantially similar technology to process paper returns;
7. Reduce the refund turnaround time to the shortest length possible. In conjunction with this initiative, publicize the *actual* range of refund delivery times;
8. Include a Revenue Protection Indicator in the acknowledgement file, which would require the IRS to run additional compliance screens, such as the Dependent Database and Criminal Investigation screens, *before* releasing the acknowledgement file;
9. Create a Treasury stored value card and immediately publicize the ability of taxpayers to use their existing stored value cards to receive refunds in the 2010 filing season;[49]
10. Develop an online account management program for taxpayers to monitor their tax accounts and resolve account issues securely over the Internet. The IRS should conduct research to determine taxpayer preferences and willingness (or obstacles) to adopt the service while it is developing its portal and e-authentication solutions; and
11. Develop servicewide e-authentication and portal strategies to securely and successfully implement any of the planned electronic services.

IRS COMMENTS

Services Strategy

The National Taxpayer Advocate correctly points out that meeting the technological preferences of taxpayers and practitioners in their interactions with the agency plays a vital role in promoting the IRS' commitment to providing "top quality" service. In fact, future budget limitations may very well challenge IRS's ability to deliver service even at existing levels unless IRS is able to improve its use of technology to meet taxpayer needs.

For this reason, the IRS continues to press for innovations and enhancements that support the Service's mission – a key component of which is developing a servicewide strategy that incorporates electronic delivery where appropriate. Much of the work for this strategy has already been developed through the Taxpayer Assistance Blueprint and IRS Strategic plan work. However, the strategy itself is not solely an "e-strategy".

Instead, the IRS has worked to address specific taxpayer and IRS needs, regardless of whether they are electronic or through other channels. Put another way, the IRS's developing e-strategy is really nothing more than an identification of those components of the overall IRS Strategic Plan that are supported by a business case justifying the electronic investments. The "e" in e-strategy is there only because it recognizes that electronic methods are frequently the most cost-effective way of delivering particular solutions.

Since 2007, the IRS has refocused and restructured its Strategic Plan to reflect a new business model, one that is based on research and recommendations from the TAB. Updated annually, the TAB is a joint response of the IRS, the IRS Oversight Board, and the National

[49] *See* National Taxpayer Advocate 2008 Annual Report to Congress 427-41.

Taxpayer Advocate to a congressional mandate that IRS develop a five year plan for taxpayer services. The TAB's precepts for improving taxpayer services from the taxpayer's perspective are embodied in the IRS Strategic Plan. Business Operating Division (BOD) internal planning documents and IRS budget proposals are directly linked to the Strategic Plan. Because the Strategic Plan embodies the goals and objectives of the TAB, functional plans and budget proposals already maintain reference to the taxpayer-centric, research-driven development and administration of customer services, including e-services.

As a result, the IRS already has most of the components of an overarching strategy for the development, implementation, and improvement of e-services, as recommended by the National taxpayer Advocate. However, it lacks a comprehensive picture or plan of the way forward to the next set of electronic investments. To address this need, the IRS is forming a new and dedicated e-services governance body that will cross-functionally plan and manage future e-product investments to ensure alignment with the overall IRS Strategic Plan.

2009 Accomplishments

IRS.gov was fully operational for the filing season and included a series of improvements to enhance the user experience. The IRS delivered new capabilities to taxpayers and our employees, such as a rotating spotlight, improved form pick list, enhanced search functionality, and improved reporting capabilities. As of November 8, 2009, IRS.gov has been visited more than 275 million times, resulting in more than 1.5 billion page views.[50] IRS.gov's American Customer Satisfaction Index score held steady at 72 for the filing season—the new capabilities delivered this year helped IRS meet America's expectation to connect with the government online in the same way they do when completing other financial transactions online.

The IRS launched Free File Fillable Forms, a new and free electronic filing option enabling virtually all taxpayers to prepare and electronically file their federal income tax returns without charge. The IRS partnered with the Free File Alliance to implement Fillable Forms in less than five weeks before the start of 2009 filing season. We led the development of system requirements and of a comprehensive internal and external communication strategy that included training for toll free, walk-in, and IRS.gov assistors. The IRS monitored the new functionality and managed errors and rejects throughout the filing season. Over 268,000 citizens successfully filed their 2008 federal return using Free File Fillable Forms. More than 3.2 million taxpayers were able to file their returns using Free File services and our relationship with the Free File Alliance.[51] This also enabled us to influence leaders in the tax software industry to eliminate their electronic filing fees, which contributed to an increase of over 19 percent in returns filed online from home computers.[52]

50 IRS, *IRS.gov Weekly Site Usage Report, week ending Nov. 7, 2009*.

51 IRS, Daily E-File At A Glance (Oct, 20, 2009).

52 IRS News Release, *Two Out of Three Individuals Now Using IRS E-file*, IR-2009-99, (Nov. 2, 2009) (on file with author).

The IRS developed six (6) new security, privacy, and business standards to better serve taxpayers and protect their information collected, processed, and stored by authorized IRS e-file providers participating in Online Filing of individual income tax returns. These new standards are intended to supplement the Gramm-Leach-Bliley Act and the Federal Trade Commission's implementing rules and regulations. We vetted the standards internally across the IRS and with our industry technical partners. The objectives of these standards are to:

- Establish minimum encryption standards for transmission of taxpayer information over the Internet and authentication of website owners/operators beyond that offered by standard version security certificates;
- Periodic external vulnerability scan of the taxpayer data environment;
- Protection against bulk-filing of fraudulent tax returns; and
- The ability to isolate and investigate potentially compromised taxpayer information with agility.

These standards also address certain customer service objectives, such as instant access to website owner/operator's contact information and e-file providers' commitment to maintaining physical, electronic, and procedural safeguards that comply with applicable law and federal standards. We are on track to implement the new standards for Filing Season 2010.

The IRS successfully deployed Modernized e-File (MeF) Release 5.5 on January 5, 2009, for the 2009 filing season and implemented all tax year changes and provisions of the Economic Stimulus Act and Recovery Act legislation. Through November 22, 2009, MeF has accepted over 4.7 million tax returns/extensions, representing a 38 percent increase in the volume received during the same time in 2008.[53] The MeF program enhanced customer service to business filers by enabling e-filing of several new tax forms/credits resulting from the Economic Stimulus Act and Recovery Act legislation.

In addition, Form 1040 Phase I (MeF Release 6.1) successfully completed a critical project milestone on December 4, 2008. This means IRS is on track to add Forms 1040, 4868, and 21 other 1040-related forms and schedules to the 1040 MeF platform in February 2010 – the first phase of a three-year deployment that will ultimately allow IRS to serve all individual taxpayers using the modernized e-file system.

When fully implemented, MeF will give taxpayers peace of mind about their returns and allow them to fix errors in near real time. It will do this by acknowledging returns quickly, providing clear and understandable messages about problems with returns, accepting amended and prior year returns, and providing data in a format that will allow the IRS to deliver better taxpayer service.

53 IRS, *MeF Executive Report for week ending Nov. 22, 2009*.

Phishing and Fillable Forms

The National Taxpayer Advocate cites the occurrence of highly-publicized phishing schemes as a reason the IRS should develop a free fill-in template and direct filing portal and notes the possibility that Free File users may confuse a legitimate Free File site with a phishing site.

While a general concern about phishing is well founded, this recommendation is off the mark. The IRS has taken steps to ensure the integrity of the Free File program – in part by prohibiting access to Free File sites except through the IRS website. Taxpayers may access Free File sites only by logging on to IRS.gov – a fact our marketing efforts stress.

The truth is taxpayers will continue to receive phishing e-mails from scammers regardless of whether the IRS develops its own free fill-in template and direct filing portal. Combating phishing and other kinds of scams will require ongoing communication and education. In this regard, the IRS reminds consumers to avoid identity theft scams that use the IRS name, logo, or a similar website address in an attempt to convince taxpayers that the scam is a genuine communication from the IRS. Scammers may also use other federal agency names, such as the U.S. Department of the Treasury. The IRS has issued several recent consumer warnings on the fraudulent use of the IRS name or logo by scammers trying to gain access to consumers' financial information in order to steal their identity and assets. The IRS further publicizes the fact that it does not initiate taxpayer contact via unsolicited e-mail or ask for personal identifying or financial information via e-mail.

It is also important to point out that with the development of Free File Fillable Forms, all taxpayers have the option to prepare and file their federal income tax returns through the IRS's own website. Traditional Free File remains limited to the 70 percent of taxpayers with incomes at or below $57,000 but anyone can use Fillable Forms. The National Taxpayer Advocate further states that the IRS exerts little control over the contents of the various Free File programs. In fact, the IRS includes service and usability standards in its agreement with the Free File Alliance to ensure consistency and quality services across all Free File companies. If companies do not comply with the standards, the IRS reserves the right to remove their company listing from IRS.gov or suspend the company from the IRS e-file program.

Response to Recommendations

1. The IRS agrees with the National Taxpayer Advocate's recommendation that the IRS develop a cross-functional e-services task force to determine the service delivery preferences and needs of taxpayers. As noted above, IRS is establishing a cross-functional e-services governance body to review and approve future e-products proposals. The new governance body will review and evaluate proposals to ensure alignment with the IRS Strategic Plan and for business value.

2. We agree with the National Taxpayer Advocate's recommendation to review services provided by other governmental authorities and private industry, identify services the IRS should offer in electronic format, and determine how to improve current services. Duties of the e-services governance body will include developing those components of the overall IRS services strategy that should be e-enabled. As part of its deliberations, the e-services governance body will take into consideration the experiences of other governmental authorities and private industry. This information will be included in the servicewide framework for evaluating investment options and a governance process for making informed investment decisions.

   While this work is still in process, the IRS has already completed a short-term research study that looked specifically at service options and ongoing customer satisfaction surveys to develop a framework for evaluating service investments. From that work, the IRS identified 14 quick-hits pertaining to existing electronic services that offer opportunities to enhance our e-services portfolio. Grouped under the categories of usability, improved marketing, enhancements and policy changes to existing e-services, these quick-hits will provide short-term guidance for investment and planning purposes until the longer-term strategy is complete.

3. The IRS respectfully disagrees with the National Taxpayer Advocate's recommendation with regard to the e-Council. The e-Council was designed to function as a community of practice, not a decision-making body. As such, it is open to all interested parties across the IRS. The goal of the Council is to share information about interesting technology developments either within the IRS or in the business community. It does not function as a review or governance body. Those roles are reserved for other executive steering committees including the Services Committee – which already has the features the National Taxpayer Advocate recommends with regard to membership and process.

4. The IRS agrees in principle with the recommendation to conduct a study similar to the TAB for both Small Business/Self-Employed division (SB/SE) taxpayers and exempt organizations to determine the service needs of these taxpayer populations, including their e-service needs and preferences. In fact, we are already conducting a taxpayer survey among those taxpayers who file a Form 1040 and those who file a Form 1040 with a Schedule C, E, or F. The main objective is to determine if the current electronic applications and services that are available to the individual taxpayers are sufficient and what other needs or requests they may have. The survey will be done by telephone – interviewing possibly 1,000 taxpayers in each segment. The target completion date is February 2010.

   In addition, to support these studies the IRS is developing an e-product evaluation process that will provide a framework for prioritizing e-products and services. A scoring tool will provide the Business Operating Divisions (BODs) with a standard list of questions to answer regarding their e-product ideas. This will provide the

critical information needed to assess alignment with the IRS Strategic Plan, likelihood of a project's success, and customer value before significant time and effort is spent on development.

As the IRS evaluates and refines the TAB during its annual update for Congress, the outcome of these BOD evaluations, including those related to tax exempt organizations, will be factored into the TAB's outline for the development and administration of cost effective, customer-needs driven services, including e-services. Further, as part of recent work agreed to within the Services Committee, IRS National Research will be leading an effort including SB/SE, TE/GE, LMSB, and TAS to gather and review all recent IRS research covering taxpayer segments. The objective of this effort is to determine where additional research is required and develop plans to fill any existing gaps in the research.

5. With regard to recommendations around the electronic filing template and a direct filing portal to provide a free government-sponsored method to electronically file returns, the IRS has already incorporated significant improvements to the filing template – improvements consistent with the National Taxpayer Advocate's recommendations. In addition, the IRS already provides a free, government-sponsored method to electronically file returns through Free File. A direct filing portal is not necessary to support this approach and is not essential to increasing electronic filing.

   A variety of different filing options were recently reviewed as part of the Advancing e-File Study Phase II. As the study notes, the only thing that will achieve dramatic increases over the natural growth in e-filing is a requirement that return preparers file electronically – a requirement that was recently enacted as part of the Worker, Home Ownership and Business Assistance Act of 2009. With this new statutory requirement, the IRS anticipates a significant growth in electronic filing.

6. With regard to 2-D barcoding, the IRS has considered and proposed several approaches to 2-D barcoding and/or optical character recognition. In general, the options considered have been part of larger initiatives which were delayed because of lack of funding. The recent enactment of an e-file mandate for most return preparers has now caused the IRS to reconsider the approach to "residual paper" returns. While we will have to wait until that analysis is completed, it seems likely that 2-D barcoding, or some similar technology, will be part of the ultimate solution.

7. With regard to refund turnaround time, the IRS is working to shorten the amount of time it takes to process a return and deliver a refund. In fact, the CADE – an ongoing technology investment project – is enabling the IRS to significantly increase the speed with which returns are processed and refunds are issued. Further, the IRS does publicize estimates of refund turnaround times. In fact, the IRS has used the difference between electronic and paper filing times to help drive e-file take up. However, recent research conducted for the Advancing E-File study suggests those marketing and

communications efforts have run their course – meaning refund timeliness no longer appears to be a significant driver in the taxpayer use of e-file.

8. The IRS does not concur with the recommendation to provide a Revenue Protection Indicator (RPI) in the acknowledgement file. Unlike the debt indicator, which identifies outstanding financial obligations that will affect taxpayers' refunds, an RPI would indicate a potential, unexplained problem the IRS may or may not subsequently choose to pursue. Because IRS systems cannot, at the time of initial returns processing, determine with certainty whether a taxpayer's return will be examined or otherwise questioned, an RPI is not feasible. The IRS also has significant concerns about the potential such an indicator would have for providing a roadmap to IRS enforcement selection criteria. Electronic interactions afford users with greater potential to test IRS systems and to extract patterns from data, with attendant risks to IRS compliance programs.

9. With regard to the recommendation to create a Treasury stored value card and immediately publicize the ability of taxpayers to use their existing stored value cards to receive refunds in the 2010 filing season, the IRS is not currently implementing a national debit card strategy. Rather, based upon the business model described below, the IRS will review information and results from those partners participating in debit card initiatives and then make an appropriate decision on scalability.

   Currently, IRS partners are the resource for implementation of local and national debit card strategies. The IRS serves as the facilitator of this process. The IRS, through its partners, is working to increase direct deposit accessibility and positively impact service options to underserved taxpayers through the use of debit cards. Establishing modified bank account access via a debit card for federal/state tax refunds is an option several IRS partners have embraced. Several national partners are discussing initiating debit card projects in FY 2010.

10. The IRS agrees with the National Taxpayer Advocate's recommendation to develop a research-based plan for delivery of account or account-like services to taxpayers and has taken some preliminary steps in that direction – most notably *Where's My Refund* and *What Was My Stimulus Payment* that are available through IRS.gov. We believe that an online account capability may ultimately be part of the suite of services provided to taxpayers.

    However, evidence from other countries as well as state governments suggests online accounts may not enjoy the kind of usage associated with similar applications in the private sector, such as online banking. In fact, these examples, as well as the IRS's own limited experience, suggest much larger numbers of taxpayers may be served by simple, direct "utilities" that take care of specific activities taxpayers desire. An example of this might be an application that allows taxpayers to obtain "certified" copies of IRS transcripts – copies that will satisfy mortgage or education lenders. For this reason, we agree with the National Taxpayer Advocate

that research on the issue is needed in support of the e-services component of the overall services strategy discussed earlier.

The IRS is also working to address one key component of any online service strategy: authentication. As the information or services provided to taxpayers becomes more sensitive and as the nature of the transactions becomes more sensitive, the level of certainty about the identity of the individual who has logged on to perform the tasks grows. While the IRS has simple forms of authentication for specific functions (*Where's My Refund* requires the user to know the amount of the refund expected, for example), we lack systems that will support more sensitive types of transactions – such as providing taxpayers the ability to access and resolve account issues online.

While the IRS is working on these more challenging forms of authentication, it is important to point out that the type of authentication required can limit the willingness of taxpayers to use the service. For example, several other countries have found that taxpayers are much more likely to use a service if they can log on and use it immediately – by providing some basic information or shared secrets in exchange for the ability to get a piece of data like *Where's My Refund*. When the authentication requirements are more burdensome and cannot be completed in the same session, the take up falls dramatically. In addition, even when taxpayers are willing to authenticate by waiting for a confirmatory code or PIN in the mail, for example, experience suggests they often allow these codes or PINs to lapse – requiring additional work by the taxpayer and the IRS to revalidate.

These complexities underscore the need for the IRS to test and evaluate taxpayer reactions and to avoid jumping to conclusions about what should be provided – an online account or any other particular application. The National Taxpayer Advocate's recommendation supports the IRS' approach to conducting a data-driven, taxpayer-focused process to build an approach the IRS believes will yield the best outcomes.

11. Finally, the IRS agrees with the recommendation to develop servicewide e-authentication and portal strategies to securely and successfully implement any of the planned electronic services and is already taking steps in both areas. Specifically with regard to an authentication strategy, the IRS has already commissioned a working group to develop such a servicewide strategy. The strategy will apply across all channels: web, telephone, paper mail, and walk-in. The group has developed requirements for identity proofing and authentication solutions for low and moderate risk transactions and has developed a risk assessment process and evaluation tool in partnership with the IRS Cybersecurity organization. It is now focused on the specific technology solutions that will be needed to support these requirements.

In addition, the IRS has already developed a comprehensive Portal Strategy. Completed in January 2009, the strategy assessed business needs, technology directions, operating models, contract approach, governance structures, and key implementation priorities. The implementation plan outlined five core initiatives some of which are underway – others have not yet begun: 1) Complete the portal contracts transition, 2) Clean up content and redesign navigation of IRS.gov, 3) Improve e-services reliability, 4) Develop an overall return-preparer/third party services strategy, 5) Create a unified IRS employee intranet providing consistent look and feel.

The portal strategy addresses the IRS's immediate, most pressing web requirements, accounts for specific Web initiatives such as those outlined in the TAB, and recognizes the evolving nature of Web service delivery to provide a broad set of strategic options. The current plan calls for a complete replacement of IRS.gov and the infrastructure supporting it over the next three years. Coupled with the ongoing development of the e-component of the TAB and IRS Strategic Plan, discussed earlier, the IRS will be positioned to deliver significant increases in taxpayer service over coming years.

Taxpayer Advocate Service Comments

Need for e-Services Strategy

The National Taxpayer Advocate is pleased that the IRS is creating an e-governance body. The Taxpayer Advocate Service looks forward to participating in this initiative. Based on the IRS's response, the IRS has the components of an e-services strategy and plans to do the necessary research to implement it properly. We agree with the IRS that an e-services strategy would be a mere component of the overarching IRS Strategic Plan. However, it is more effective for servicewide consistency purposes to develop a sub-strategy dedicated solely to e-services rather than plan *ad hoc* electronic services pursuant to the Strategic Plan. The IRS faces many of the same issues when planning new electronic services. These common issues include, but are not limited to: (1) e-authentication, (2) portals, (3) capacity, (4) data security, (5) compliance with § 508 of the Rehabilitation Act, and (6) usability testing. An e-services strategy would address these issues and provide a well-designed roadmap for the planned cross-functional e-services governance body, which should include representation from TAS.

IRS Accomplishments

The National Taxpayer Advocate commends the IRS for its significant achievements in offering electronic services. The IRS provides a very impressive array of electronic services

to taxpayers. However, the IRS appears to plan these services on an *ad hoc* basis rather than under a comprehensive servicewide strategy.

Phishing and Fillable Forms

The National Taxpayer Advocate continues to believe the existence of phishing schemes is one factor supporting the need for the IRS to develop its own free fill-in template and portal. A significant percentage of taxpayers may not be aware that all Free File sites are only accessible through the IRS's website at the time they receive a phishing scheme solicitation. It is not necessarily intuitive to believe that one can only access a commercial website through a government site. Even if they are well-informed about accessibility of the Free File sites, users may feel at risk once they are redirected off the IRS website onto a commercial one. In addition, taxpayers may not trust the data security protections provided by a commercial program as much as they trust government protections, and they may intuitively search for an IRS-sponsored program on the IRS's website.

The National Taxpayer Advocate also does not believe that the Free File Fillable Forms program is an adequate substitute for a government-sponsored program. While the IRS may negotiate service and usability standards for Free File programs, it is unclear whether the IRS adequately enforces these standards. The IRS also does not exert complete control over which forms are supported by each of the programs. Finally, the program does not allow users to store the tax return on the user's own computer, a limitation which could undermine taxpayer usage and increase taxpayers' security concerns.

TAB for SB/SE Taxpayers and Exempt Organizations.

The IRS states it agrees in principle with our recommendation to conduct a study similar to the TAB for SB/SE taxpayers and exempt organization. It also lists preliminary steps to develop these studies. The Taxpayer Advocate Service looks forward to working closely with the IRS in determining gaps and methodology for the research for these populations.

Return Processing

The advent of a preparer e-file mandate has enabled the IRS to reconsider its approach to paper returns. The National Taxpayer Advocate is pleased that the IRS is considering incorporating barcoding or similar technology into its solution. This change in position will benefit both the IRS and taxpayers in the long term.

The IRS notes that recent research indicates that IRS's marketing communications efforts have run their course in attempting to increase the e-file rate. The research found that refund turnaround times may no longer be a significant driver in the use of e-file. However, the National Taxpayer Advocate questions this conclusion. In fact, the high rate of refund anticipation loan usage contradicts this conclusion. The quick receipt of refund proceeds is a significant contributing factor in the decision to purchase a RAL. In addition, poor

economic conditions and high unemployment rates only support the need to get the money into taxpayers' hands as quickly as possible.

The IRS cites two main reasons for disagreeing with the recommendation to provide a Revenue Protection Indicator in the acknowledgement file. The first reason is the inability to provide certainty during initial processing stages about whether the IRS will actually examine a return. However, financial institutions would nonetheless benefit from this additional "less than accurate information" by reducing defaults on refund anticipation loans. The banks would just need to factor the uncertainty of the RPI into their risk analyses. The IRS's second reason to reject this recommendation is a valid concern that the RPI will provide a road map for selection criteria. However, this concern applies with the current system – only the roadmap is available further down the line. Nonetheless, the IRS would need to design the RPI to minimize this risk.

Stored Value Card Strategy

The IRS needs to offer a government debit card rather than merely facilitating stored value cards offered by its partners. The IRS has less control over the terms of the commercial cards, including the amount of fees charged. In addition, the federal government already has experience issuing SVCs. For example, the Department of Treasury has partnered with the Social Security Administration in the Direct Express program which offers SVCs for Social Security and Supplemental Security Income (SSI) recipients.

It is inconceivable that the IRS refuses to announce the ability of taxpayers to use existing SVCs, including those provided through the above-mentioned Direct Express program, to receive refunds during the 2010 filing season. The IRS can tack this information onto planned filing season communications and save some taxpayers the expense of incurring the fees associated with commercial refund delivery products, such as RALs.

Online Account Management

The IRS claims an online tax account tool may have lower participation rates than traditional online banking tools. However, this assertion ignores the TAB recommendation for the IRS to develop service delivery channels similar to those offered by many large financial institutions.[54] The IRS also points to the low participation rates for similar tools provided by other foreign and state government bodies. However, it is unclear how these governments promoted such tools and whether they had the functionality demanded by potential users. If the IRS develops an online account tool, it should first conduct market research to determine the features preferred and demanded by taxpayers, and develop the tool to meet those needs.

[54] IRS Pub. 4579, 2007 *Taxpayer Assistance Blueprint Phase 2* (Apr. 2007), Service Improvement Portfolio.

Recommendations

We are pleased that the IRS in its response has agreed to do or consider the following:

1. Create a cross-functional e-services governance body which will review and evaluate e-product proposals to ensure alignment with the IRS Strategic Plan. Such body will consider the experiences of other governmental authorities and private industry;
2. Conduct a study similar to the TAB for both Small Business/Self-Employed (SB/SE) taxpayers and exempt organizations;
3. Implement 2-D barcoding or similar technology to process paper returns; and
4. Develop servicewide e-authentication and portal strategies to securely and successfully implement proposed electronic services.

In addition to the above, the National Taxpayer Advocate recommends that the IRS take the following administrative steps to meet the taxpayers' needs for electronic services:

1. Improve the filing template and develop a direct filing portal to provide a free government-sponsored method to electronically file returns and store such returns on the taxpayers' own computers;
2. Reduce the refund turnaround time to the shortest length possible. In conjunction with this initiative, publicize the *actual* range of refund delivery times;
3. Include a Revenue Protection Indicator in the acknowledgement file, which would require the IRS to run additional compliance screens, such as the Dependent Database and Criminal Investigation screens, *before* releasing the acknowledgement file;
4. Create a Treasury stored value card and immediately publicize the ability of taxpayers to use their existing stored value cards to receive refunds in the 2010 filing season;[55] and
5. Develop an online account management program for taxpayers to monitor their tax accounts and resolve account issues securely over the Internet. The IRS should conduct research to determine taxpayer preferences and willingness (or obstacles) to adopt the service while it is developing its portal and e-authentication solutions.

[55] *See* National Taxpayer Advocate 2008 Annual Report to Congress 427-41.

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

RESPONSIBLE OFFICIALS

Richard E. Byrd Jr., Commissioner, Wage & Investment Division
Chris Wagner, Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM[1]

Individuals with incomes below the poverty level make up 12.5 percent of the United States population, or 37 million people.[2] These taxpayers often face distinctive issues, and therefore need customized IRS service and enforcement approaches, fine-tuned for their specific needs and preferences.[3] Low income taxpayers may possess some or all of the following characteristics that present challenges to tax administration:

- Limited English proficiency;
- Limited computer access;
- Low literacy rates;
- Disabilities; or
- Lower education levels.

Notwithstanding their income levels, low income taxpayers frequently have tax problems, including:

- Taxpayers who claim the Earned Income Tax Credit (EITC) are more likely to be audited than other taxpayers;[4]
- Cancellation of debt income (CODI) issues, other than mortgage debt, are more likely to arise, and taxpayers cannot receive assistance with these issues at Volunteer Income Tax Assistance (VITA) or Tax Counseling for the Elderly (TCE) sites;

1 For purposes of this analysis, a low income taxpayer is defined as one whose income is at or below 250 percent of the poverty level as established by the Office of Management and Budget and as referenced in the statutory language authorizing the Secretary of Treasury to provide grants to Low Income Taxpayer Clinics (LITCs). Internal Revenue Code (IRC) § 7526.

2 *See* U.S. Dept. of Health and Human Services (HHS), *Annual Update of the HHS Poverty Guidelines, 74* Fed. Reg. *4199-4201 (Jan. 23, 2009); U.S. Census Bureau, Age and Sex of All People, Family Members and Unrelated Individuals Iterated by Income-to-Poverty Ratio and Race: 2007, available at* http://www.census.gov/hhes/www/macro/032008/pov/new01_100_01.htm (last visited July 20, 2009).

3 Such a customized approach is especially important in light of the current economic downturn and a high unemployment rate.

4 IRS 2008 Data Book, Table 9a, *available at* http://www.irs.gov/pub/irs-soi/08db09aex.xls (last visited Nov. 16, 2009). In fiscal year (FY) 2008 the audit rate for individual returns was approximately 0.7 percent, while the audit rate for EITC returns was approximately 2.1 percent, approximately triple the rate for returns that did not claim the EITC.

- Independent contractor versus employee classifications are more likely to be contentious; and
- Liens attaching to taxpayer accounts in currently not collectible (CNC) status do not secure any government interest and significantly limit taxpayers' access to credit.

The IRS does not specifically tailor its programs to the needs and preferences of this taxpayer segment, instead providing "one size fits all" service. In addition, the IRS does not actively partner with TAS and the Low Income Taxpayer Clinics on all issues affecting low income taxpayers, thus failing to use all available resources to develop the programs, outreach, and education that these taxpayers need to overcome the barriers they face to receiving IRS services.

ANALYSIS OF THE PROBLEM

What constitutes low income?

For purposes of this analysis, a low income taxpayer is defined as one whose income is at or below 250 percent of the poverty level as established by the Office of Management and Budget and as referenced in the statutory language authorizing the Secretary of Treasury to provide grants to LITCs.[5] In 2009, the poverty guidelines for the 48 contiguous states and the District of Columbia are:

TABLE 1.6.1, U.S. Poverty Guidelines

Persons in Family	Poverty Guideline* [6]	LITC 250% [7]
1	$10,830	$27,075
2	$14,570	$36,425
3	$18,310	$45,775
4	$22,050	$55,125
5	$25,790	$64,475
6	$29,530	$73,825
7	$33,270	$83,175
8	$37,010	$92,525

*For families with more than eight persons, add $3,740 for each additional person.

5 IRC § 7526. The 250 percent guideline is derived from the need to provide assistance not just to those who are poverty-stricken, but also to those who fall into the category of the working poor. For example, resolving a case with the IRS or litigating a case in the U.S. Tax Court can be prohibitively expensive, and it is not just those at the poverty level who cannot afford representation. *See Taxpayer Rights Proposals and Recommendations of the National Commission on Restructuring the Internal Revenue Service on Taxpayer Protections and Rights: Hearing Before the H. Comm. on Ways and Means Subcomm. on Oversight*, 105th Cong. (Sept. 26, 1997) (statement of Nina E. Olson, Executive Director, The Community Tax Law Project).

6 HHS, *Annual Update of the HHS Poverty Guidelines*, 74 Fed. Reg. 4199-4201 (Jan. 23, 2009).

7 IRS Pub. 3319, *2010 Grant Application Package and Guidelines* (May 2009).

In 2007, the U.S. Census Bureau reported that 118 million individuals fell below 250 percent of the poverty level.[8] In tax year (TY) 2006, individual taxpayers filed approximately 140 million returns,[9] of which approximately 62 million or about 44 percent of all individual tax returns reported income at or below 250 percent of the poverty level, measured in terms of adjusted gross income (AGI).[10]

The current economic downturn may create an entirely new population of taxpayers who have become low income for the first time. As of November 2009, the U.S. unemployment rate stood at 10 percent, up from 7.6 percent in January 2009, and up from 5.6 percent in June 2008.[11] Many taxpayers may have significantly reduced incomes, may be encountering financial difficulties such as foreclosure, or may be eligible for the EITC for the first time. These taxpayers may differ from the traditional low income taxpaying population in that they may have bank accounts and be computer literate but still need IRS assistance. They may also be feeling shame or depression about their newly impoverished circumstances. However, the IRS lacks a defined strategy for dealing with those who are facing unprecedented economic difficulties, which may result in different treatments for similarly situated taxpayers. Additionally, while this new low income population may need customized assistance, it is crucial that the IRS not forget the needs of chronically low income taxpayers.

"Being poor is a full time job, it really is."[12]

Although a diverse population, low income taxpayers do share common characteristics. Low income taxpayers are found more frequently among the elderly,[13] the disabled,[14] Native Americans, and taxpayers who may have limited English proficiency (LEP) relative to the general Wage and Investment (W&I) taxpayer population. Many require extra assistance to understand tax law changes, as demonstrated by the widespread confusion about the 2008 Economic Stimulus Payment (ESP) and the resulting flood of calls to the IRS toll-free

8 U.S. Census Bureau, *Age and Sex of All People, Family Members and Unrelated Individuals Iterated by Income-to-Poverty Ratio and Race: 2006 Below 250% of Poverty – All Races, available at* http://pubdb3.census.gov/macro/032007/pov/new01_250_01.htm (last visited July 20, 2009). 118,077,000 individuals fell at or below 250 percent of the poverty level in 2006.

9 IRS, *Table 1.2, All Returns: Adjusted Gross Income, Exemptions, Deductions, and Tax Items, by Size of Adjusted Gross Income and by Marital Status, Tax Year 2006, available at* http://www.irs.gov/pub/irs-soi/06in12ms.xls (last visited July 15, 2009). 138,394,754 individual returns were filed in for tax year 2006.

10 IRS, Compliance Data Warehouse (CDW), Individual Returns Transaction File, TY 2006. In tax year 2006, 61,774,757 individual returns were filed with income levels at or below 250 percent of poverty level, measured based on AGI.

11 Department of Labor, *Labor Force Statistics from the Current Population Survey, available at* http://data.bls.gov/PDQ/servlet/SurveyOutputServlet?data_tool=latest_numbers&series_id=LNS14000000 (last visited Dec. 15, 2009).

12 David K. Shipler, The Working Poor, Invisible in America 230 (Alfred A. Knopf, 2004).

13 W&I Research, W&I Senior Population (Age 55 and Over), Project No. 7-03-16-2-027N (Nov. 2003), *available at* http://win.web.irs.gov/spec/docs/WISeniorPopulation-ExecutiveSummary.ppt#377,10 (last visited Sept. 28, 2009).

14 National Disability Institute, *available at* http://reitour.org/docs/annualreports/2007-08FinalTourReport.pdf. *See also* U.S. Census Bureau, *Survey of Income and Program Participation, June–September 2005, available at* http://www.census.gov/hhes/www/disability/sipp/disab05/ds05rf4.pdf (last visited Sept. 28, 2009).

line.[15] Low income taxpayers tend to be more transitory than the general population, with 27.5 percent of those below the poverty level moving in 2007 while only 15 percent of the general population moved during the same time.[16]

Low income taxpayers face often disabling environmental obstacles to overcoming poverty and its effects. Family income has a significant impact on what young children achieve later in life.[17] The lack of transportation and accessible child care services limit the poor's ability to earn income.[18] There are costs to being poor. Living in some poor neighborhoods restricts residents' access to banks, since many such places have no bank branches, offering only expensive check-cashing services, loan sharks, or subprime lenders.[19] These neighborhoods are also home to tax return preparers who service recipients of the EITC, a refundable tax credit for low-wage working families. The preparers promise a rapid refund to those in immediate financial need, but it comes with myriad fees and an exorbitant cost to the poorest taxpayers.[20] The poor may not have access to remedies that require money.[21] And many working poor single parents expend an inordinate effort juggling, predicting, and planning any matter involving money, no matter how small.[22]

Why do low income taxpayers have tax issues?[23]

EITC claims can create problems.

The EITC, which provides relief to the working poor, is a refundable tax credit.[24] This means that if the credit due to the taxpayer exceeds the tax owed, the taxpayer receives a

15 *Hearing on Status of Economic Stimulus Payments, Subcomm. on Oversight and Social Security of the H. Comm. on Ways and Means*, 108th Cong. (June 19, 2008) (testimony of Nina Olson, National Taxpayer Advocate).

16 U.S. Census Bureau, *American FactFinder, 2007 American Community Survey 1-Year Estimates, Table, B07012, available at* http://factfinder.census.gov/servlet/DTTable?_bm=y&-geo_id=01000US&-ds_name=ACS_2007_1YR_G00_&-_lang=en&-mt_name=ACS_2007_1YR_G2000_B07012&-format=&-CONTEXT=dt (last visited Oct. 28, 2009).

17 Gordon Dahl and Lance Lochner, *The Impact of Family Income on Child Achievement; Evidence from the Earned Income Tax Credit* 24 (Institute for Research on Poverty, Discussion Paper No. 1361-09, Jan. 2009), *available at* http://www.irp.wisc.edu/publications/dps/pdfs/dp136109.pdf.

18 David K. Shipler, The Working Poor, Invisible in America 45, 52 (Alfred A. Knopf, 2004).

19 *Id.* at 18, 20, 23. There are a dozen national "payday loan" chains that charge fees of more than 500 percent annualized interest.

20 Steven Holt, Brookings Inst., *The Earned Income Tax Credit at Age 30: What We Know* 21-22 (2006), *available at* http://www.brookings.edu/reports/2006/02childrenfamilies_holt.aspx (last visited Sept. 29, 2009). *See also* David K. Shipler, The Working Poor, Invisible in America 13-16 (Alfred A. Knopf, 2004).

21 Legal Services Corporations, *Strategic Directions 2006-2010* (2006). *See also* David K. Shipler, The Working Poor, Invisible in America 25, 57 (Alfred A. Knopf, 2004). An indigent may find it an insurmountable expense to hire an attorney and pay the filing fee for bankruptcy court.

22 David K. Shipler, The Working Poor, Invisible in America 27 (Alfred A. Knopf, 2004).

23 For additional information on tax issues faced by low income taxpayers, see Leslie M. Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, Kansas Law Review, 51 U. Kan. L. Rev. 1145 (2003) ; Janet R Spragens & Nina E. Olson, *Tax Clinics: The New Face of Legal Services*, Tax Notes, Sept. 18, 2000; Nancy Abramowitz & Janet R. Spragens, *Low-income Taxpayers and the Modernized IRS: A View from the Trenches*, Tax Notes, June 13, 2005, at 107; The Community Tax Law Report, *available at* http://www.ctlp.org/newsletter.html (last visited Oct. 15, 2009).

24 Census data illustrate that in 2003, the EITC lifted 4.4 million people out of poverty, including 2.4 million children. The EITC moves more children out of poverty than any other single program or category of programs. Robert Greenstein, Center on Budget and Policy Priorities, *The Earned income Tax Credit: Boosting Employment, Aiding the Working Poor* (2005).

refund for the difference.[25] In 2007, among taxpayers claiming the EITC and a refund, the average EITC claimed was $2,071 with an average AGI of $15,990.[26]

The EITC is complex, creating problems for taxpayers who try to benefit from the credit. Confusing rules surround the process of correctly reporting family status and whether a child is a "qualifying child" for purposes of the EITC. Taxpayers who claim the EITC are more likely to be audited than any other group, increasing the need for low income taxpayers to have access to representation to defend their claims.[27] In FY 2008, taxpayers who claimed the EITC accounted for 36 percent of all individual taxpayer audits.[28]

Cancellation of Debt Income Raises Complicated Issues.[29]

Low income taxpayers may find themselves having to report cancellation of debt income from events ranging from car repossession to mortgage foreclosure.[30] While taxpayers may be required to report CODI on their tax returns, the IRS does not offer tax preparation for CODI at VITA[31] or TCE[32] sites unless the CODI results from a mortgage on the taxpayer's primary residence. This policy may help taxpayers who have lost their homes to foreclosure but it does not help low income taxpayers who have CODI from other sources or have used home equity loans to pay non-home related expenses such as medical bills.[33] Like the standards for the EITC, CODI rules are complex and confusing. For example, taxpayers must make difficult calculations to attempt to determine if they can exclude CODI under the insolvency exception.[34] CODI presents significant challenges to low income taxpayers who may not be able to afford an attorney or accountant. As a result, taxpayers eligible for the insolvency exception may be assessed CODI-related tax which they do not actually owe.

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25 IRS, *It's Easier than Ever to Find Out if You Qualify for EITC, available at* http://www.irs.gov/individuals/article/0,,id=96406,00.html (last visited July 15, 2009).

26 IRS, Compliance Data Warehouse (CDW), Individual Returns Transaction File, TY 2007.

27 IRS 2008 Data Book, Table 9a, *available at* http://www.irs.gov/pub/irs-soi/08db09aex.xls (last visited Nov. 16, 2009). In FY 2008 the audit rate for individual returns was approximately 0.7 percent, while the audit rate for EITC returns was approximately 2.1 percent, approximately triple the rate for returns that did not claim the EITC.

28 IRS, *FY 2008 Data Book*, Table 9a (36.3 percent or 503,755 EITC audits, 1,391,581 individual returns audited in total).

29 For a detailed discussion of the complexity of CODI issues, see National Taxpayer Advocate 2008 Annual Report to Congress 39-53 and National Taxpayer Advocate 2007 Annual Report to Congress 13-34.

30 IRC § 61(a)(12) (stating that gross income includes "[i]ncome from discharge of indebtedness").

31 VITA provides free tax preparation and often tax filing services to low to moderate income taxpayers. For purposes of the VITA program, low income is identified as adjusted gross income at or below the maximum EITC income limit, which for tax year 2008 was $38,646 ($41,646 if married filing jointly). IRS Form 1040 Instructions 2008.

32 TCE provides tax counseling and preparations services for taxpayers over the age of 60. IRS, *Tax Counseling for the Elderly, available at* http://www.irs.gov/individuals/article/0,,id=109754,00.html (last visited July 16, 2009).

33 Cancellation of debt 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 instances involving refund anticipation loans (RALs), where a taxpayer used the proceeds from the RAL to make a down payment on a more expensive vehicle than the taxpayer could normally 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*, 109th Cong. (2005) (testimony of Nina E. Olson, National Taxpayer Advocate).

34 IRC § 108(a)(1)(B).

Who is an independent contractor and who is an employee?

An employer's decision whether to classify a worker as an independent contractor or an employee creates tax consequences for both the worker and the employer.[35] The misclassification of workers as independent contractors can affect a worker's right to employer-provided health care and retirement plans, unemployment insurance, a minimum wage, and overtime pay, among many other benefits that taxpayers classified as employees are entitled to claim.[36] Further, an "independent contractor" must pay estimated taxes, including self-employment taxes, and is responsible for the entire burden of Social Security and Medicare taxes, whereas an employer must contribute half the Social Security and Medicare taxes for an employee.[37] LITC offices report seeing cases where employers misclassify workers intentionally to save money.[38] Some clinics find such misclassification is traditional in certain industries, while other clinics report that employers seem to know it is illegal and will change classifications when pressed.[39] Not only does misclassification harm employees, it causes the IRS to lose revenue, with an IRS estimate from 1984 putting lost revenue at $1.6 billion per year.[40] Many low income taxpayers may be unable to secure representation to contest the worker misclassification by requesting relief from the IRS or the Social Security administration.[41]

Federal Tax Liens Wreak Havoc on Low Income Taxpayers' Financial Future.

IRS practices can result in liens being filed on taxpayers whom the IRS has already placed in currently not collectible status due to financial hardship.[42] The IRS may grant CNC status to a taxpayer who cannot pay a tax debt, based on his or her financial status.[43] In such cases, many taxpayers may have no available assets against which the IRS can collect, and the filing of a lien damages the taxpayer's credit score.[44] Taxpayers in this situation

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35 *See generally* IRC §§ 3101, 3102, 3111-3113, and 3121-3128 (Federal Insurance Contributions Act); IRC §§ 3301-3311 (Federal Unemployment Tax Act); IRC §§ 3401-3407 (collection of income at source on wages); and IRC § 6302(g) (deposits of Social Security taxes).

36 *Economic and Societal Costs of Poverty: Hearing of the Comm. on Ways and Means Subcomms. on Income Security and Family Support and Select Revenue Measures*, 110th Cong. (Jan. 24, 2007) (testimony of Sigurd R. Nilsen, Director Education, Workforce, and Income Security Government Accountability Office).

37 Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2009-30-035, *While Actions Have Been Taken to Address Worker Misclassification, an Agency-Wide Employment Tax Program and Better Data Are Needed* (Feb. 4, 2009).

38 E-mails from LITC directors (on file with author).

39 *Id.*

40 Government Accountability Office (GAO), GAO-07-859T, *Employee Misclassification: Improved Outreach Could Help Ensure Proper Worker Classification* (May 2007) (citing an unpublished IRS report entitled *Strategic Initiative on Withholding Noncompliance*).

41 A taxpayer who believes he or she has been misclassified as an independent contractor has to file Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*, and receive a determination letter from the IRS stating whether or not he or she is an employee. The determination process might take "at least six months." IRS, *Independent Contractor (Self-Employed) or Employee?, available at* http://www.irs.gov/businesses/small/article/0,,id=99921,00.html (last visited Sept. 28, 2009).

42 Liens may be filed when 1) an installment agreement is arranged that does not meet guaranteed, streamlined, or in-business trust fund criteria; 2) an account is being reported as currently not collectible; and 3) an account with assessed and unassessed modules is being reported as currently not collectible. Internal Revenue Manual (IRM) 5.12.2.4.1 (May 20, 2005). Although the IRS is required to make reasonable efforts to contact the taxpayer before filing an NFTL, personal contact (in person or by telephone) is not required. IRM 5.12.2.3 (May 20, 2005).

43 IRS, Currently Not Collectible, *available at* http://win.web.irs.gov/compliance/compliance_sccb_5.htm (last visited Oct. 15, 2009).

44 TAS teleconference with Vantage Score® officials (Sept. 14, 2009); TAS teleconference with FICO® officials (Sept. 18, 2009). *See also* e-mail communications from Vantage Score (Sept. 17, 2009) and FICO (Sept. 23, 2009) (on file with the National Taxpayer Advocate).

may then be denied necessary loans or services or forced to pay exorbitant interest rates or fees, further reducing their ability to rectify their economic problems. Like the automated imposition of the Federal Payment Levy Program (FPLP), filing of liens without careful review of the taxpayer's situation harms low income taxpayers and impairs their future economic well-being.[45]

Using the Tax Code to Administer Social Programs[46]

In 2008, the IRS distributed stimulus payments in accordance with the Economic Stimulus Act of 2008.[47] Low income taxpayers were eligible for up to $600 per adult and $300 per eligible child in a family, depending on their income levels, or were eligible for $300 if they had at least $3,000 in earned income in 2007.[48] Many taxpayers eligible for the payments had either never filed a tax return before or had not filed in many years because their income levels did not require them to do so.

The stimulus payment is only one example of Congress using the IRS to deliver economic or social benefits to taxpayers. Many of these programs, including the EITC, affect low income taxpayers. This continued use of the IRS to promote and distribute such programs requires the IRS to have a strategy to address the needs of low income taxpayers. The IRS needs to know how to reach these taxpayers, how they respond to various types of outreach and education, how they prefer to receive service from the IRS, and how well they can comply with the requirements and instructions related to these programs.[49]

Congress and the IRS recognize that low income taxpayers need help.

Several programs, including LITC, VITA,[50] and TCE,[51] indicate that the IRS and Congress understand that the low income population needs representation and tax preparation assistance. In 1998, Congress enacted the IRS Restructuring and Reform Act of 1998 (RRA 98), which authorized $6 million in matching grants for LITCs, launching a new era in low

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45 For an in-depth discussion of lien issues, *see* Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of the Law, Fail to Promote Future Tax Compliance, and Unnecessarily Harm Taxpayers, supra.*

46 For an in-depth discussion of refundable credit issues, see *Running Social Programs Through the Tax System*, vol. 2, *infra*.

47 Pub. L. No. 110-185, 122 Stat 613 (2008).

48 *Id.*

49 The IRS could use a cognitive research lab to test how low income taxpayers respond to IRS products, outreach and education programs, and service delivery methods. For a detailed discussion, *see* Most Serious Problem: *The IRS Should Develop an In-House Cognitive Research Lab to Understand Taxpayer Behavior and Devise More Effective Products and Programs, infra.*

50 For example, in FY 2008, Congress appropriated not less than $8 million to establish and administer matching grant funds for Community Volunteer Income Tax Assistance Programs. Using the grant program, the IRS funded 2727 VITA sites for filing season 2009. Stakeholder Partnerships, Education and Communication Taxpayer Assistance Reporting System (June 30, 2009). In FY 2008, Congress appropriated not less than $3 million for TCE grants. Pub. L. No. 110-161.

51 Through a partnership with the AARP, TCE operates more than 7,000 Tax-Aide sites nationwide to help low income to moderate income taxpayers, with special attention paid to those over the age of 60. IRS, *Tax Counseling for the Elderly, available at* http://www.irs.gov/individuals/article/0,,id=109754,00.html (last visited July 16, 2009).

income taxpayer outreach, education, and representation.[52] In subsequent years, Congress has appropriated additional funding, permitting TAS to award grants to more clinics. For the 2009 grant cycle, 162 clinics received total funding of $9.5 million, with clinics operating in every state, the District of Columbia, and Puerto Rico.[53]

LITC Services

LITCs may represent taxpayers in controversies with the IRS, provide tax outreach and education to taxpayers who speak English as a second language (ESL), or both. In 2009, 20 clinics handled only ESL services, 45 provided only controversy services, and 97 offered both.[54] During the 2008 grant year, the LITC program assisted 30,648 taxpayers through controversy services and worked 37,391 issues, including 3,520 levy issues, 1,684 lien issues, 2,999 CNC issues, and 1,791 installment agreement issues.[55] The clinics opened 10,142 cases and submitted 1,804 cases to the U.S. Tax Court.[56]

In 2008, the LITCs conducted 8,890 outreach and education events.[57] These events reached 154,527 ESL taxpayers. Additionally, clinics provided one-on-one consultations with 29,342 ESL taxpayers.[58] Efforts of ESL clinics to educate taxpayers, through outreach events and educational workshops, provide service to large numbers of taxpayers and generate awareness of the clinic program among those who may need assistance.

The IRS can use LITCs as a resource to monitor issues that affect low income taxpayers and provide first-hand knowledge of how IRS programs impact, positively or negatively, low income taxpayer populations. The IRS should partner with TAS to obtain LITCs' suggestions whenever it designs programs and products that impact low income taxpayers.

What should be done to meet low income taxpayers' needs?

Create a low income taxpayer strategy.

The IRS needs a comprehensive, research-based strategy to address the needs of low income taxpayers.[59] The IRS should partner with TAS to conduct this research and consult with the LITCs as it develops a low income taxpayer strategy, which must address the needs

52 For background information, see Pub. L. No. 105-206, 112 Stat. 720 (1998); IRS Pub. 3319; Taxpayer Rights Proposals and Recommendations of the National Commission on Restructuring the Internal Revenue Service on Taxpayer Protections and Rights: Hearing Before the H. Comm. on Ways and Means Subcomm. on Oversight, 105th Cong. (Sept. 26, 1997) (statement of Nina E. Olson, Executive Director, The Community Tax Law Project); IRS Restructuring: Hearing Before the S. Comm. on Finance, 105th Cong. (Feb. 5, 1998) (statement of Nina E. Olson, Executive Director, The Community Tax Law Project); Taxpayer Advocate Report and Low-Income Taxpayer Clinics: Hearing Before the H. Comm. on Ways and Means Subcomm. on Oversight, 107th Cong. (July 12, 2001) (statement of Nina E. Olson, National Taxpayer Advocate).

53 Data on file with the LITC Program Office.

54 *Id.*

55 *Id.*

56 *Id.*

57 *Id.*

58 *Id.*

59 *See, e.g.*, IRS Oversight Board, *Customer Service and Channel Preference Survey*, 2006; National Taxpayer Advocate 2006 Annual Report to Congress vol. 2 (*Study of Taxpayer Needs, Preferences, and Willingness to Use IRS Services*); IRS, Taxpayer Assistance Blueprint, 2006.

of low income Small Business/Self-Employed (SB/SE) taxpayers as well as individuals. In creating any programs, outreach, or education based on research for the low income taxpayer strategy, the IRS should use the proposed Cognitive Research Lab to ensure that these initiatives meet the taxpayers' needs and are designed in a way that low income taxpayers can comprehend and comply with.[60]

Address areas where current practices do not meet the needs of low income taxpayers.

Use the Offer In Compromise Program.

The IRS does not use the offer in compromise (OIC) program effectively to assist taxpayers who cannot pay their full tax debts. Instead, it often places taxpayers with low incomes and few or no assets into CNC status and files liens against them, further degrading their ability to obtain credit and making it more difficult for these taxpayers to maintain or improve their economic futures.[61] Instead, the IRS should use its authority to accept low dollar offers from low income taxpayers where circumstances warrant and allow these taxpayers to get a fresh start.[62] Doing so would bring these taxpayers into compliance and provide them with the opportunity to satisfy their outstanding tax liability with the IRS, without a nagging tax debt that continues to accrue penalties and interest charges and is impossible to pay in full.

Test New Programs to Assist Taxpayers with the EITC.

The IRS has established an EITC Program Office to coordinate EITC efforts across the various IRS functions and provide a more seamless EITC experience. The National Taxpayer Advocate commends this effort and applauds the IRS's continued dedication to EITC Awareness Day, an annual nationwide outreach event. However, the EITC remains a source of confusion for taxpayers, as demonstrated by the high rate of math and other errors on tax returns claiming the credit.[63] The IRS should expand the work of the EITC Program Office to take a holistic approach to the EITC. IRS compliance employees need special training in interviewing taxpayers during EITC audits. The IRS also should design its audit process to recognize the difficulty that taxpayers may have in navigating the IRS and fulfilling its demands. Taxpayers are more likely to benefit from outbound IRS calls explaining what is required of them than from solely receiving correspondence that many may find incomprehensible. Additionally, the IRS should pilot a face-to-face EITC audit program to

60 For a detailed discussion of the Cognitive Learning Lab, *see* Most Serious Problem: *The IRS Should Develop an In-House Cognitive Research Lab to Understand Taxpayer Behavior and Devise More Effective Products and Programs, infra.*

61 Liens may be filed when (1) an installment agreement is arranged that does not meet guaranteed, streamlined, or in-business trust fund criteria; (2) an account is being reported as currently not collectible; and (3) an account with assessed and unassessed modules is being reported as currently not collectible. IRM 5.12.2.4.1 (May 20, 2005). Although the IRS is required to make reasonable efforts to contact the taxpayer before filing an NFTL, personal contact (in person or by telephone) is not required. IRM 5.12.2.3 (May 20, 2005).

62 For a detailed discussion of OICs, *see* Most Serious Problem: *The Steady Decline of the IRS Offer in Compromise Program is Leading to Continued Lost Opportunities for the IRS and Taxpayers Alike, infra.*

63 IRS, FY 2008 Data Book, Table 15. 578,337 returns claiming the EITC contained math errors.

determine if taxpayers receive better results when they can ask questions in person as the audit proceeds.[64]

The Need for LITCs Outstrips Available Funding.

LITCs fill a crucial service in tax administration by providing representation to those who would otherwise not have it, especially in matters like EITC audits, which are specific to low income taxpayers. A review of all EITC audits in 2004 found taxpayers who were represented fared substantially better than others without representation. Nearly twice as many audited taxpayers with representation were found eligible for the EITC.[65] Similarly, taxpayers with representation retained, on average, 45 percent of the EITC compared to 25 percent for taxpayers without representation – nearly twice as much.[66] Increased funding for the matching grant program would permit more clinics to be funded to help meet the representation needs of low income taxpayers.

IRS Should Partner with TAS to Improve Service to Low Income Taxpayers.

TAS intends to undertake at least two projects in FY 2010 that directly involve the needs of low income taxpayers. One project is a needs assessment for low income taxpayers, focusing on post-filing needs and looking closely at the services LITCs offer these taxpayers after they file their returns. TAS also is partnering with the LITCs and representatives of taxpayers with disabilities to produce training videos for IRS employees on working with taxpayers who have special needs, many of whom are also low income. Specifically, the videos will focus on controversy situations, but will also address phone and face-to-face contacts. We invite the IRS to work with TAS on these initiatives and commit to using the products, especially since the needs assessment will further the mission of the IRS's Taxpayer Assistance Blueprint.

What does the IRS do?

Congress enacted the FPLP in 1997, permitting the IRS to levy up to 15 percent of certain federal benefits paid to taxpayers,[67] most often Social Security. In 2008, the IRS assessed more than two million FPLP levies, with 83 percent attached to Social Security benefits.[68] Failure to screen low income taxpayers from the FPLP may result in the IRS continuously taking up to 15 percent of the taxpayer's sole source of income. TAS has suggested testing a filter, using data already in the possession of the IRS, to screen out low income taxpay-

64 National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, 107 (Research Report: *IRS Earned Income Credit Audits – A Challenge to Taxpayers*). More than 70 percent of taxpayers surveyed for this report prefer to communicate with the IRS in a manner other than correspondence when facing EITC audits.

65 *See* National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2 (Research Report: *IRS Earned Income Credit Audits – A Challenge to Taxpayers*).

66 *Id*.

67 Taxpayer Relief Act, Pub. L. No. 105-34, § 1024, 111 Stat. 788, 923 (1997); IRC § 6331(h).

68 *See* IRS, W&I spreadsheet, *FPLP Monthly Counts*, FY 2008 [1,797,530 (total number of FPLP Social Security Administration levy payments received in fiscal year 2008) / 2,161,974 (total number of all FPLP levy payments received in FY 2008) = 83 percent].

ers from the FPLP.[69] The IRS will implement a screen at 250 percent of the poverty level effective January 2011. The National Taxpayer Advocate commends the IRS for responding to the concerns that TAS has raised regarding the lack of a screen and looks forward to the completion of this project.[70]

CONCLUSION

Low income taxpayers face distinctive barriers to receiving IRS services. However, the IRS lacks a research plan or a comprehensive strategy addressing the needs and preferences of this taxpayer segment. Without such measures, the IRS cannot hope to address service or enforcement concerns of low income taxpayers. The IRS should use the resources available, such as TAS and the LITCs, at the earliest stages when it plans changes to policies, guidance, programs, outreach, education, or notices that affect that low income taxpayer population. With the increasing tendency to administer economic or social initiatives targeted to low income taxpayers through the tax code, the need to reach this population takes on an even greater sense of urgency. The IRS should create a research plan and develop a low income taxpayer strategy for W&I and SB/SE taxpayers; it should partner with TAS and the LITCs at the inception of projects that will affect low income taxpayers; and it should create and use a Cognitive Research Lab that could test products, outreach, and educational efforts that affect low income taxpayers.[71]

In conclusion, the National Taxpayer Advocate offers these preliminary recommendations:

1) Partner with TAS and the LITCs as it develops programs affecting low income taxpayers.
2) Create a comprehensive outreach, education, and research plan to address the needs and preferences of low income taxpayers in both the W&I and SB/SE divisions.
3) Test programs and products that affect low income taxpayers in the Cognitive Research Lab.
4) Partner with TAS to complete a post filing needs assessment of low income taxpayers.
5) Partner with TAS to create training videos on working with taxpayers with special needs.

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69 National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, 46-73 (*Building a Better Filter: Protecting Lower Income Social Security Recipients from the Federal Payment Levy Program*). Congress enacted the FPLP in 1997, permitting the IRS to levy up to fifteen percent of certain federal benefits paid to taxpayers. Most commonly, the FPLP attaches to Social Security benefits. *See generally* IRC § 6331(h).

70 For a detailed discussion of the National Taxpayer Advocate's recommendations regarding an FPLP screen, see Status Update: *Federal Payment Levy Program: IRS Agrees to Low Income Taxpayer Filter, infra*; National Taxpayer Advocate 2008 Annual Report to Congress vol. 2 46-73 (*Building a Better Filter: Protecting Lower Income Social Security Recipients from the Federal Payment Levy Program*); National Taxpayer Advocate 2007 Annual Report to Congress 324-36 (Most Serious Problem: *FPLP Levies on Social Security Benefits*); and National Taxpayer Advocate 2006 Annual Report to Congress 110-29 (Most Serious Problem: *Levies*).

71 *See* Most Serious Problem: *The IRS Should Develop an In-House Cognitive Research Lab to Understand Taxpayer Behavior and Devise More Effective Products and Programs, infra.*

6) Create business measures that assess the impact of IRS programs on low income taxpayers.

IRS COMMENTS

The IRS disagrees with the National Taxpayer Advocate's assertions that taxpayer service programs are not tailored to the needs of low income taxpayers. Aware of the potential difficulties of such programs as EITC and sensitive to the challenges faced by low income taxpayers, the IRS puts forth substantial effort to ease these taxpayers' burden and to provide them services. In addition, since 2007, the IRS Strategic Plan has been restructured to reflect and include recommendations from the Taxpayer Assistance Blueprint (TAB). Updated annually, the TAB is a joint response of the IRS, the IRS Oversight Board, and the National Taxpayer Advocate to a congressional mandate that IRS develop a five year plan for taxpayer services. The TAB's research-based recommendations for improving taxpayer services were developed from the taxpayer's perspective, including those with low income.

Serving Taxpayers

In addition to providing service to low income taxpayers through over 400 Taxpayer Assistance Centers (TACs), toll-free phones, and IRS.gov, the IRS provides targeted assistance to low income taxpayers through its VITA and TCE programs.[72] These volunteer programs rely on partnerships with community-based organizations to increase the economic well being of shared customers. As stated on IRS.gov, "the VITA Program offers free tax help to low- to moderate-income (generally, $49,000 and below) people who cannot prepare their own tax returns. Certified volunteers sponsored by various organizations receive training to help prepare basic tax returns in communities across the country."[73] In December 2007, Congress appropriated funds for the IRS to establish and administer a matching grant program for community volunteer income tax assistance. This funding allowed the IRS to provide grants to partner organizations to better enable the VITA program to extend services to underserved low income populations in hardest-to-reach areas, both urban and non-urban. The IRS provided grants to 111 organizations for tax year 2008 and recently awarded 147 grants to organizations for tax year 2009. Through the VITA and TCE programs, the IRS and its partners are committed to providing top quality taxpayer service, tax law information, and financial literacy education to low income taxpayers and other vulnerable groups. These services include free tax return preparation for low income taxpayers including the elderly, disabled, rural, Native Americans, and persons with limited English proficiency. During the 2009 filing season, almost 83,000 IRS-supported volunteers prepared over three million federal tax returns and more than two million state tax returns at VITA and TCE sites. These returns were prepared for taxpayers with an average AGI per return of $21,680.00,[74] which reflects the low income focus of these programs.

72 IRS, *Volunteer Income Tax Assistance*, http://win.web.irs.gov/spec/docs/Vol_Prgms/VITA_History_101509.pdf (last visited Nov. 16, 2009).

73 IRS, *Free Tax Return Preparation for You by Volunteers*, http://www.irs.gov/individuals/article/0,,id=107626,00.html, (last visited Nov. 16, 2009).

74 IRS, *Taxwise* Efile data.

Furthermore, during the FY 2009 filing season, the IRS's TACs collaborated with partners to provide low income taxpayer account-related assistance at several VITA sites and plans to expand this service in 2010 to as many as 30 locations.[75]

Misclassification of Workers: Contractor vs. Employee

To help explain the difficulties faced by low income taxpayers, the National Taxpayer Advocate describes several specific circumstances where thoughtful and targeted assistance from the IRS may be required. One such circumstance is the misclassification of workers as a contractor or an employee. The IRS agrees with the National Taxpayer Advocate that misclassification of a worker's status as an employee versus independent contractor can have a significant impact. We encourage workers who feel they are misclassified to file Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding,* to receive a determination letter from the IRS. Workers are not required to secure representation to file this form and, regardless, will be treated in a fair and impartial manner. Information on requesting a determination can be found on IRS.gov.[76] That web page also provides information for misclassified workers regarding Form 8919, *Uncollected Social Security and Medicare Tax on Wages,* which can be used to figure and report the employee's share of uncollected Social Security and Medicare taxes due on their compensation. This form may be filed if the worker meets one of several criteria including where the worker has filed Form SS-8 with the IRS and has not yet received a reply.

Filing of Liens

Another circumstance of potential burden and confusion is filing of liens. The IRS believes that only after careful review and consideration of a taxpayer's situation are liens filed on cases placed in the Currently Not Collectible status due to hardship. Prior to placing a taxpayer's account in CNC status due to hardship, the IRS employee must secure and carefully review required financial information. This careful and thorough review ensures that the employee is aware of, and considers, the taxpayer's current financial situation when making a determination to place the account in CNC status due to hardship and whether or not to file a lien on the CNC case.

It is important to note that the primary purpose of the Notice of Federal Tax Lien is to protect the government's priority over other creditors. This is especially critical when a taxpayer files for bankruptcy protection. Absence of a lien filing in bankruptcy situations could provide a disadvantage to the taxpayer and an unfair advantage to other creditors.

Earned Income Tax Credit

Another circumstance defined by the National Taxpayer Advocate as warranting specific attention to better serve low income taxpayers is the EITC. The IRS already conducts

[75] IRS, *FY 2010 Program Letter*, http://win.web.irs.gov/field.htm (last visited Nov. 16, 2009).

[76] IRS, *Independent Contractor (Self-Employed) or Employee?*, http://www.irs.gov/businesses/small/article/0,,id=99921,00.html (last visited Dec. 3, 2009).

extensive outreach activities focusing on EITC, including National EITC Awareness Day, to educate low income taxpayers on qualifications for the credit. The IRS also partners with local and national community and charitable organizations to leverage their trusted relationships with eligible taxpayers to increase EITC awareness and encourage participation, while potentially reducing erroneous claims. Importantly, the IRS has already established a cross-functional team that includes TAS Research, the W&I and SB/SE operating divisions, and the EITC Office with the goal of identifying and testing possible improved communications to help EITC taxpayers navigate the examination process and better understand and meet documentation requirements. The team is currently considering many of the EITC-related recommendations the National Taxpayer Advocate mentions in this report. The IRS and the National Taxpayer Advocate share a common goal of ensuring all eligible taxpayers receive the EITC to which they are entitled.

Offers in Compromise

The National Taxpayer Advocate suggests that OICs are a possible area of unnecessary burden and confusion for low income taxpayers. An OIC is a viable payment alternative for all taxpayers, including low income taxpayers that are not able to pay in full. To proactively address such issues, the IRS has taken steps to ensure the program is accessible to taxpayers that qualify, especially low income taxpayers. If a taxpayer qualifies for the low income waiver, we waive both the application fee and the payments required upon receipt and during the investigation of the offer. In February 2007, the IRS raised the low income standards to include those taxpayers with income at or below 250 percent of the federal poverty level as defined by the Department of Health and Human Services. As a result of this change, the number of OICs processed under the revised low income guidelines increased from 6.8 percent in fiscal year 2006 to 29.9 percent in fiscal year 2009.[77] In February 2009, we also revised our procedures to fully investigate OICs submitted by qualifying low income taxpayers, even without the upfront required forms and/or payments.[78]

Cancellation of Debt Income

Due to complexity of the CODI issues, IRS partners at VITA and TCE sites were only able to provide assistance with tax return preparation covering CODI from mortgages on the taxpayer's primary residence. To supplement the efforts of the IRS's volunteer partners, the IRS offers assistance at its over 400 TACs with all tax law inquiries and return preparation for all CODI except business and farm income. Tax law and account assistance related to CODI, including business and farm income, is also available through the IRS's nationwide, toll-free telephone service.

While the National Taxpayer Advocate notes that CODI presents significant challenges to low income taxpayers, IRS experience during the 2009 filing season indicates there is not

77 IRS, *Offer in Compromise Executive Summary* (Sept. 30, 2009); *Offer in Compromise Executive Summary* (Sept. 30, 2007).

78 IRS, Interim Guidance Memorandum SBSE-05-0209-005, *Interim Guidance for Low Income Processability Procedures*.

a large demand for assistance on this topic. While data is not available for the volunteer sites, through April 9, 2009, demand for CODI-related service at the IRS TACs included approximately 1,600 contacts out of a total of three million. Of these 1,600 CODI-related contacts, only 103 involved farm or business debt and thus were beyond the scope of assistance offered by the TACs.[79] During roughly the same period, IRS estimates it answered 41,600 telephone calls related to CODI out of a total volume of approximately 16 million assistor calls answered.[80]

IRS Comments on Preliminary Recommendations

1. **Recommendation:** Partner with TAS and the LITCs as programs affecting low income taxpayers are developed.

   While discussing the problems faced by low income taxpayers as a most serious problem, the National Taxpayer Advocate asserts that "the IRS does not actively partner with the Taxpayer Advocate Service (TAS) and the Low Income Taxpayer Clinics (LITCs) on all issues affecting low income taxpayers, thus failing to use all available resources to develop the programs, outreach, and education that these taxpayers need to overcome the barriers they face to receiving IRS services." On the contrary, the IRS has a history of successfully partnering with TAS and LITCs on important issues that may affect low income taxpayers including EITC issues and programs. For example:

   - The IRS partnered with TAS in designing the EITC residency certification study and secured LITC input through roundtables and focus groups. TAS and LITC input was important in designing the forms, letters and procedures used in the FY 2004 – FY 2006 tests. In fact, to make their communication more effective, the IRS arranged for a group of LITC clinicians to hold a seminar with examiners to help the examiners gain a better understanding of the taxpayers they would be serving. The IRS and TAS also partnered to develop an LITC Residency Certification Guide to assist the LITCs to guide their clients in completing the appropriate forms and gathering the necessary information to meet the test requirements.
   - TAS was an active partner in the major revisions for the 2005 filing season EITC examination letters and the correspondence audit process publication. This partnership resulted in Publication 4134, *Low Income Tax Clinic Listing*, becoming a standard enclosure to EITC examination letters. The LITC listing provides a list of LITCs by location and language services offered. TAS has since partnered with the IRS even more recently to update that publication.

[79] Field Assistance operational data: Q-matic workload management system and Field Assistance Management Information System, Business Objects report generation software.

[80] JOC Enterprise Snapshot Report for April 11, 2009, total Customer Account Services (CAS) assistor calls answered. Estimated number of CODI-related calls based on Centralized Quality Review System sample of tax law calls through April 13, 2009.

- Through the collaborative efforts of TAS, the EITC Office, and SB/SE, the IRS is poised to test the use of a third-party affidavit as alternative documentation to prove the residency requirement during an EITC examination.[81] While the IRS already provides numerous documentation options to taxpayers that are explained in the EITC document request, Form 886-H-EIC, the IRS is partnering with TAS to test the expanded use of these affidavits, originally tested during the certification initiative. The National Taxpayer Advocate expressed an interest in this form of documentation in her Most Serious Problem, *Exam Strategy – EITC Examinations and the Impact of Taxpayer Representation*, in her 2007 Annual Report to Congress.

With regard to the remaining preliminary recommendations listed below, as well as other suggestions received throughout the year, the IRS looks forward to working with TAS and the LITCs on cost-effective efforts that will lead to providing more and better services for taxpayers.

2. **Recommendation:** Create a comprehensive outreach, education, and research plan to address the needs and preferences of low income taxpayers in both the W&I and SB/SE divisions.

In addition to urging attention to specific circumstances that may provide difficulty for low income taxpayers, the National Taxpayer Advocate urges the IRS to create a "comprehensive outreach, education, and research plan to address the needs and preferences of low income taxpayers in both W&I and SB/SE divisions." In fact, several integrated planning efforts already address the needs of low income taxpayers. For example, W&I Research conducts an "environmental scan" describing trends in the W&I taxpayer population for integration into the W&I Operations Plan. This research includes emphasis on underserved groups, including taxpayers with low English proficiency, elderly taxpayers, taxpayers with disabilities, and a section specifically covering "low income" taxpayers.[82]

In addition to the efforts spearheaded by the W&I Research function, the Communications, Liaison, and Disclosure (CLD) function of SB/SE implemented comprehensive outreach and education plans to address the needs and preferences of low income Spanish speaking taxpayers. This includes translating various educational products into Spanish. They have translated into Spanish and provided captioning for a webinar on IRS Disaster and Emergency Relief[83] and are working on Spanish translations for 11 top small business videos on various topics of interest for posting to "IRS.gov en Espanol" in early 2010.

81 Third parties within this study include: Child care provider (cannot be a relative), health care provider, social service or other government official, court or placement agency official employer, landlord or property owner, school official, Indian tribal official, and clergy.

82 IRS, *FY10-11 WIOP Environmental Scan Orig by WIRA* (Nov. 4, 2009).

83 The webinar is on the Small Business Audio and Video Presentations page on IRS.gov at http://www.irs.gov/businesses/small/article/0,,id=97726,00.html.

A variety of materials for use in stakeholder outreach is provided in the Outreach Initiatives Database (OID). There is a topic in the OID on *Communicating with the IRS in Spanish.* An "English/Spanish" option to the OID was added and there are currently 18 topics offering Spanish-language outreach materials. Topics include Language Services (with guidance for getting documents translated), Economic Hardships, ARRA provisions, Choosing a Tax Preparer, Phishing, Identity Theft, and more. The Stakeholder Liaisons in CLD also partner with non-IRS experts to deliver Spanish-only Small Business Tax Workshops. These workshops offer a valuable community service and presenters can earn continuing professional education credits.

Beyond focusing on taxpayers with English as their second language, CLD has many outreach tools and initiatives that deal with other lower income segments of the population. We use the OID to ensure delivery of consistent messages by the Stakeholder Liaisons. Some topics include: First Time Homebuyer Credit, Effects of Economic Hardship, Recruiting & Hiring, New Schedule C Initiative, Education Tax Credits, and the Making Work Pay Credit, as well as presentations on the IRS on YouTube.

The IRS also approaches understanding the needs of low income taxpayers at the enterprise level. As part of recent work agreed to within the Services Committee, IRS National Research will be leading an effort including SB/SE, Tax Exempt & Government Entities (TE/GE), Large and Mid-Size Businesses (LMSB), and TAS to gather and review all recent IRS research covering taxpayer segments, including low income taxpayers. The objective of this effort is to determine where additional research is required and develop plans to fill any existing gaps in research.

As an immediate supplement to this comprehensive collaborative effort, the SB/SE Research function will initiate a research project to profile low income taxpayers in the small business and self-employed customer base to determine the attributes of a low income taxpayer within the SBSE population and to determine if this population has any special service needs.

3. **Recommendation:** Test programs and products that affect low income taxpayers in the Cognitive Research Lab.

With respect to the National Taxpayer Advocate's specific recommendation to establish an IRS Cognitive Learning Lab, the IRS responded to this same issue elsewhere in this report as well as for the National Taxpayer Advocate's 2007 and 2008 Annual Reports to Congress. As noted in those responses, the TAB project began the process of assembling what is known in this area and prompted supplemental work with original survey and behavioral research focused on the needs and desires expressed by taxpayers about taxpayer service. More recently, at the request of the National Taxpayer Advocate and the remainder of the Services Committee,

the IRS is evaluating all TAB-related research and other taxpayer studies to identify areas where increased research is warranted.

In addition, a $5 million budget initiative specifically aimed at improving and understanding the link between provision of services to taxpayers and their impact on taxpayer compliance is underway. This initiative allowed the IRS to embark on a multi-year research agenda that could eventually pay large dividends through improved voluntary compliance. However, these results may or may not validate the National Taxpayer Advocate's proposal that utilizing a cognitive and behavioral lab would be an effective strategy for advancing research in this area. Because of the extensive research already completed for the TAB, the IRS now knows more than ever before about taxpayer needs, preferences and behaviors. At this point, the IRS believes a cognitive learning lab would be premature and possibly redundant in light of the research efforts already underway.

4. **Recommendation:** Partner with TAS to complete a post filing needs assessment of low income taxpayers.

   The National Taxpayer Advocate suggests that the IRS partner with TAS to assess the post filing needs of low income taxpayers. In fact, the forum and process to address such needs already exist. Each year, the EITC Office works with functional coordinators throughout the IRS, including TAS, to assess the needs of low income taxpayers and develop strategies to increase EITC visibility and participation. The goal is to connect with hard-to-reach taxpayer segments, such as the limited English proficient, rural, and others. This year, the EITC Office also sponsored an EITC stakeholder summit for all IRS functions to discuss new and innovative ways to reach low income taxpayers and how, as an agency, the IRS can coordinate and improve outreach initiatives to better meet the post filing season needs of this demographic. This group will continue to meet to discuss progress in this area and the IRS looks forward to continuing TAS participation.

5. **Recommendation:** Partner with TAS to create training videos on working with taxpayers with special needs.

   The IRS remains deeply committed to creating an atmosphere of diversity and inclusion for its employees and the taxpayers it serves. Through partnering programs with organizations like the National Disabilities Institute (NDI), hiring initiatives focusing on prospective disabled employees, and program offices such as the Information Resource Accessibility Program (IRAP),[84] the IRS maintains an organization eager to celebrate and accommodate all differences among taxpay-

[84] At IRAP, the mission is to enable accessible IT through integrated solutions, services and standards. Through IRAP's role in the creation of facilitated self-assistance, the same attention to accessibility and usability given to IRS employees is provided to taxpayers seeking service. http://irap.web.irs.gov/miss-struc.asp (last visited Nov. 16, 2009)

ers and IRS employees. These efforts keep partners, IRS workers and technology attuned to a wide variety of special needs.

To optimize taxpayer service interactions, the IRS already provides training specifically designed to support productive interaction with special needs persons.[85] Course 23221, *Communication Skills for Field Assistance*, is core curriculum level material included in the first classroom training an Individual Taxpayer Advisory Specialist[86] receives. Chapter 3 of course 23221 includes information on addressing various communication challenges, including communication with the hearing impaired, visually impaired, and others. Similarly, Course 12160, *Communication Skills*, provided to Accounts Management telephone assistors, includes chapter 8, *Challenges to Communication,* which addresses communication with special needs taxpayers.[87] The IRS also provides training to aid interaction with special needs taxpayers through intermediaries.[88] Most of these courses are available in interactive electronic format and supplement other resources, such as the Diversity Toolkit provided by the Equal Employment Office of the IRS.

Where special needs can be interpreted to mean low English proficiency, the IRS also offers a variety of training for IRS personnel. Continuing Professional Education course 10227, *Spanish Communication,* is offered to both telephone and Field Assistance personnel.[89] For IRS taxpayer service personnel working through partners, the IRS offers Course 25140, *Hispanic Limited English Proficient (LEP)*. For languages other than Spanish, the IRS provides Over the Phone Interpreter (OPI) service, a telephone-based interpreter service available to taxpayers with limited or no proficiency in English.

6. **Recommendation:** Create business measures that assess the impact of IRS programs on low income taxpayers.

   To continually assess its mission to serve all taxpayers, the IRS maintains sets of balanced measures[90] relative to the full spectrum of its services and enforcement programs. Because programs such as EITC, VITA/TCE, and return preparation at TACs directly impact a greater portion of low income taxpayers, their business performance as captured by existing balanced measures already assesses their impact on low income taxpayers. Therefore, the IRS does not agree that it is necessary to create additional, potentially redundant, measures in this regard.

85 Other courses include Course 12159, *Introduction to Core Topics*. Module B covers the TTY number for deaf taxpayers and supplements core training.

86 Individual Taxpayer Advisory Specialists (ITAS) provide face-to-face service at TACs.

87 Other training material includes Course 6603, *Communication Skills*. Lesson 8 addresses the following challenges to communication: Language Barriers, Stuttering, Old Age, Illiteracy, Hearing-Impaired Taxpayers, Visually-Impaired Taxpayers.

88 Course 17850, *Disability Initiative Training – SPEC*.

89 In addition to the coverage in the core curriculum, Accounts Management Phone assistors are provided Course 12361, *Default Screener*, where Lesson 1 provides instructions on using the Telephone Transfer Guide to transfer the calling to a Spanish Application number.

90 Balanced measures include customer satisfaction, employee satisfaction, and business results.

Taxpayer Advocate Service Comments

In its response, the IRS cites its work with EITC and VITA as evidence of its strategic focus on the needs of low income taxpayers. We agree that the IRS has done significant work in these areas and in fact, in our earlier discussion, we commend the IRS on these activities. These improvements, however, have not come without considerable prompting by others to improve service to low income taxpayers. For example, the IRS says it is now testing the EITC Residency Certification Affidavit. We applaud this step, but note that the IRS is undertaking this further study only after four years of continued pressure from the National Taxpayer Advocate, notwithstanding compelling evidence from the first study that this method of documentation is the most accurate and most preferred by low income taxpayers.[91] More importantly, the IRS's response demonstrates that there is no *strategic*, cross-functional plan to address the needs of low income taxpayers, and thus there is no linkage between the information the IRS does have and application of this information to its service and enforcement activities.

In this most serious problem discussion, the National Taxpayer Advocate attempted to demonstrate to the IRS that low income taxpayers have tax problems and needs that extend far beyond return filing and the Earned Income Tax Credit. Were the IRS to explore this problem in a needs-assessment study (as other agencies charged with serving this population have done, including the Legal Services Corporation), it would discover data that shows that low income taxpayers face debt collection problems, domestic and intimate partner abuse, worker classification issues, and cancellation of debt issues, to name just a few. In fact, testimony about the sheer scope of these problems and the difficulty of this population in navigating the IRS led Congress to enact IRC § 7526, providing funding for low income taxpayer clinics.[92] The IRS itself has yet to learn this lesson.

It is true that the IRS has accumulated some research into the needs of low income taxpayers, much of which the Taxpayer Advocate Service has conducted or underwritten.[93] Yet in many areas we fail to see the IRS integrating these research findings into the IRS's day-to-

91 *See* National Taxpayer Advocate 2007 Annual Report to Congress 222-30; National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 96, 115.

92 *See Taxpayer Rights Proposals and Recommendations of the National Commission on Restructuring the Internal Revenue Service on Taxpayer Protections and Rights: Hearing Before the H. Comm. on Ways and Means Subcomm. on Oversight*, 105th Cong. (Sept. 26, 1997) (statement of Nina E. Olson, Executive Director, The Community Tax Law Project) and *IRS Restructuring: Hearing Before the S. Comm. on Finance*, 105th Cong. (Feb. 5, 1998) (statement of Nina E. Olson, Executive Director, The Community Tax Law Project).

93 National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, *The IRS's Use of Notices of Federal Tax Lien (NFTL), infra*; National Taxpayer Advocate 2008 Annual Report to Congress vol. 2 (*Building a Better Filter: Protecting Lower Income Social Security Recipients from the Federal Payment Levy Program*); National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2 (Research Report: *IRS Earned Income Credit Audits – A Challenge to Taxpayers*); National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2 (*Simulating EITC Filing Behaviors: Validating Agent Based Simulation for IRS Analyses: The 2004 Hartford Case Study*); National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2 (Leslie Book, *Study of the Role of Preparers in Relation to Taxpayer Compliance with the Internal Revenue Laws*); National Taxpayer Advocate 2006 Annual Report to Congress, vol. 2 (*Study of Taxpayer Needs, Preferences, and Willingness to Use IRS Services*); 2006 IRS Oversight Board Customer Service and Channel Preference Survey; 2004 National Taxpayer Advocate Annual Report to Congress, vol. 2 (*Earned Income Tax Credit Audit Reconsideration Study*); Leslie Book, *The IRS's Compliance Regime: Taxpayers Caught in the Net*, 81 Or. L. Rev. 351 (2002).

day activities. Nowhere is this failure to integrate more evident than in the IRS's response to our discussion of worker classification in this report.

In its response about worker classification, the IRS states that taxpayers can get information about Form SS-8 and the classification determination process on IRS.gov, and that taxpayers do not need representation to file this form. Form SS-8 is five pages long, consisting of 55 questions.[94] The Paperwork Reduction Act states that this form takes 22 hours for record keeping, 47 minutes to learn about the law or the form, and one hour, 11 minutes to prepare and send.[95] We know from the TAS research studies on EITC audits that *represented* low income taxpayers are twice as likely to receive additional EITC and receive twice as much EITC as unrepresented low income taxpayers. Thus, in complex areas of tax law, representation *does* make a *significant* difference to the outcomes for taxpayers. Most importantly, the IRS's own research shows that low income and other special needs taxpayers have inadequate access to computers and limited computer literacy.[96] In fact, a recent Washington Post article noted that while 62 percent of Americans report using a computer at home, those who do not must contend with 30-minute time limits at public libraries and other impediments to using the Internet.[97] Yet the IRS's strategy for providing assistance to low income taxpayers about worker classification is a passive one – put information up on the Internet and expect them to find it, read it, and understand it. This fundamental flaw in the IRS's understanding of the needs of low income taxpayers surfaces repeatedly throughout its response.

The National Taxpayer Advocate applauds the IRS for joining with TAS and LITCs on past and future projects that impact the low income taxpayer population. However, the National Taxpayer Advocate believes the IRS fails to involve TAS and the LITCs in projects where it does not consider the *specific* impact on low income taxpayers. The IRS bases its program planning on assumptions that have never been tested, and it shows little interest in exploring its assumptions to determine if they are aligned with reality.

For example, the IRS cites protecting the government's interest as justification for filing notices of federal tax liens where the taxpayer is currently not collectible. In the case of low income taxpayers, however, such reasons are illusory if not delusional, because these insolvent taxpayers have little or no property or interest for a lien to attach to and perfect. Filing the NFTL in such cases does not protect any government interest. Instead, it destroys the ability of disadvantaged taxpayers to secure loans at favorable interest rates, whether to pay their taxes, mortgages, or other necessities of life.

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94 IRS, *Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding* (2006).

95 *Id.*

96 IRS, Advancing E-File Study (2008); IRS, Taxpayer Assistance Blueprint Phase 2 (2007); IRS, Taxpayer Assistance Blueprint (2006); National Taxpayer Advocate 2006 Annual Report to Congress, vol. 2 (*Study of Taxpayer Needs, Preferences, and Willingness to Use IRS Services*); 2006 IRS Oversight Board Customer Service and Channel Preference Survey; 2006 Taxpayer Advocacy Panel Annual Report.

97 *See* U.S. Census Bureau, *Internet Use Triples in Decade* (2006); *Lack of Computer Access Hampers Some Students*, Washington Post, Dec. 5, 2009.

Moreover, in its response to our NFTL discussion, the IRS states that its "careful and thorough review ensures that the employee is aware of, and considers, the taxpayer's current financial situation when making a determination to place the account in CNC status due to hardship and whether or not to file a lien on the CNC case." Nothing could be further from the truth with respect to lien filing. If the taxpayer owes over $5,000 and the account is reported as currently not collectible, the IRS will file an NFTL, in many cases systemically, without any determination about whether the taxpayer has or is likely to acquire any assets to which a lien could attach.[98] The IRM requires NFTL filing for CNC accounts both when the IRS cannot locate or contact the taxpayer and when the taxpayer is experiencing an economic hardship.[99] Even though in many cases an IRS employee may have talked to the taxpayer and evaluated his or her financial information or other evidence of financial difficulty (including a medical hardship) prior to reporting the taxpayer's account as CNC (*i.e.*, unable to pay), the IRS has replaced its employees' judgment and discretion with a business rule that requires NFTL filing.[100]

A TAS analysis of collection payment data from a subset of taxpayers in CNC (hardship) status also shows that only about five percent of all payment transactions and approximately 20 percent of the total dollars collected from these taxpayers are attributable to NFTLs.[101] Automatic NFTL filing on CNC (hardship) taxpayers exacerbates their financial difficulties. Thus, the IRS should eliminate automatic NFTL filing in these cases, and instead require its employees to base filing determinations on a thorough review of the taxpayer's circumstances (including the existence and the value of assets, the taxpayer's financial information, and the effect of the lien on the taxpayer's credit rating).[102] This determination should be made after personal contact with the taxpayer and a substantive consideration of the facts, which may include consultation with a manager.[103]

In its response, the IRS states that experience has shown that CODI assistance is not in high demand. The IRS notes that approximately 1,600 contacts at TACs involved CODI income in the 2009 filing season. However, during TY 2008, approximately 1.9 million

98 IRM 5.12.2.4.1 (1) (May 20, 2005). IRS Policy Statement P-5-71 provides the IRS authority to report an account as CNC for a variety of reasons (*e.g.*, unable to pay (hardship), unable to contact or locate, and death). This generally suspends collection actions but the liability is still due and owing; thus, penalties and interest continue to accrue until the statutory period of collection expires. "Economic hardship" occurs when an individual taxpayer is unable to pay reasonable basic living expenses. *See* Proced. & Admin. Reg. § 301.6343-1(b)(4).

99 IRM 5.19.4.5.2 (Aug. 4, 2009).

100 Policy Statement P-5-71, IRM 1.2.14.1.14 (Nov. 19, 1980). *See also* IRM 5.16.1.1 (May 5, 2009); IRM 5.16.1.2.9 (May 5, 2009). The basis for a hardship determination is information about the taxpayer's financial condition provided on Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals*, or Form 433-B, *Collection Information Statement for Businesses. See also* IRM 5.15.1 (Oct. 2, 2009).

101 For more detailed discussion, *see* Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of the Law, Fail to Promote Future Tax Compliance, and Unnecessarily Harm Taxpayers*, Chart 1.2.4, Total Dollars Collected – Breakdown of Payments of CNC Hardship Individual Taxpayers, *infra. See also The IRS's Use of Notices of Federal Tax Lien (NFTL)*, vol. 2, *supra*.

102 LITCs report they are dealing with an increasing number of taxpayers who have lost their jobs during the economic downturn and were placed in CNC status. However, the IRS has liens in place for these taxpayers who want to work but are having difficulty finding employment due to the lien. ABA Section of Taxation LITC listserv submission (Nov. 4, 2009).

103 IRS Policy Statement 5-47 indicates that notices of lien will generally only be filed after the IRS contacts the taxpayer in person, by telephone, or by notice. IRM 1.2.14.1.13 (Oct. 9, 1996). A personal contact (in person or by telephone) is preferred but not required. IRM 5.12.2.3 (May 20, 2005). The National Taxpayer Advocate notes that the implementation of business rule-driven, systemic lien filing renders these policies meaningless.

taxpayers received a Form 1099-C.[104] While these taxpayers may not come to the TACs for assistance, they may come to TCE or VITA sites only to be turned away if the CODI is non-mortgage related and the IRS would not know since this information is not tracked for volunteer partner sites. The number of taxpayers with CODI continues to increase, with approximately 300,000 more taxpayers receiving a Form 1099-C in TY 2008 than in TY 2007.[105] Based on the IRS's logic, of these taxpayers, only a small number need assistance with CODI. It is equally likely that these taxpayers simply do not understand what CODI is and do not know that they need to include this income on their tax returns. The IRS should provide more education to taxpayers and practitioners about CODI.

Finally, we are saddened that the IRS has failed to accept our offer of partnership in developing an innovative approach to training its employees about working with low income and other special-needs taxpayers. We plan to have these taxpayers, and their representatives, speak for themselves in this training, and involve IRS employees in role-play to better understand the experiences of these taxpayers.[106] We again invite the IRS to partner with us in truly learning what it is like to walk in the taxpayers' shoes.

While the National Taxpayer Advocate acknowledges and commends many IRS efforts in regard to the low income taxpayer population, there is much, much more to be done. The comprehensive review of all IRS research covering taxpayer segments referenced in the IRS response is certainly a good first step in identifying gaps. Still, the National Taxpayer Advocate firmly believes an independent low income taxpayer strategy for SB/SE and W&I taxpayers is essential. Creating a comprehensive strategy, rather than integrating pieces into various other documents, would serve as a guide to the IRS rather than a piecemeal approach. The National Taxpayer Advocate urges the IRS to reconsider the development and implementation of a comprehensive low income taxpayer strategy.

The National Taxpayer Advocate takes the IRS at its word that it will partner with TAS and the LITCs and conduct a comprehensive W&I and SB/SE outreach, education, and research plan for addressing the needs and preferences of low income taxpayers with respect to service and enforcement actions. She will actively monitor the development of this plan to ensure that the IRS actually integrates this information into the service and enforcement initiatives that impact this population and uses this information to proactively identify problems and develop solutions.

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104 IRS, Compliance Data Warehouse, Information Returns Master File, TY 2008. 1,939,559 taxpayers received Form 1099-C in TY 2008.

105 IRS, Compliance Data Warehouse, Information Returns Master File, TY 2007. 1,644, 934 taxpayers received Form 1099-C in TY 2007. IRS, Compliance Data Warehouse, Information Returns Master File, TY 2008. 1,939,559 taxpayers received a Form 1099-C in TY 2008.

106 In its response, the IRS cites as an example of its partnership with TAS the fact that it arranged for a group of clinicians to speak to EITC examiners. In fact, the National Taxpayer Advocate arranged for and organized this program and offered it to the IRS; we are pleased that the IRS found the program helpful. This example, however, increases our confusion as to why the IRS would not want to undertake another training initiative in partnership with TAS, since it viewed the first one positively.

Recommendations

The National Taxpayer Advocate recommends that the IRS:

1. Test programs and products that affect low income taxpayers in the Cognitive Research Lab.
2. Partner with TAS to complete a post filing needs assessment of low income taxpayers, which would encompass issues other than EITC.
3. Partner with TAS to create training videos on working with taxpayers with special needs.
4. Create business measures that assess the impact of IRS programs on low income taxpayers.

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

RESPONSIBLE OFFICIALS

Richard E. Byrd Jr., Commissioner, Wage and Investment Division
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DEFINITION OF PROBLEM

It is estimated that more than seven million American citizens reside abroad.[1] Although taxpayers are required to file U.S income tax returns regardless of their residency status,[2] IRS data show that only 462,340 taxpayers filed returns from a foreign address in tax year (TY) 2007.[3]

U.S. taxpayers living abroad may be unaware of their filing obligations, confused by the complexity of international tax law, or overwhelmed by the prospect of figuring out what is required. IRS Publication 4732, *Federal Tax Information for U.S. Taxpayers Living Abroad*, illustrates the complexity of the filing requirements. The publication refers to at least eight other relevant IRS publications, totaling 563 pages. Further, the additional documents referred to by each publication listed in Publication 4732 include 4,727 pages of instructions, 667 pages of forms, and another 1,928 pages of form instructions, for a total of 7,322 pages.

Some of the challenges U.S. citizens residing abroad face include:

- Understanding the requirement to file U.S. tax returns when income is earned abroad;
- Understanding the need to make an election to claim the foreign earned income and foreign housing exclusions or deductions;
- Understanding the complexity of foreign tax credit rules and limitations;
- Understanding the ramifications of international tax treaty provisions; and
- Reporting items of income and expenses denominated in foreign currencies.

1 *See* IRS, *Reaching Out to Americans Abroad* (Apr. 2009), http://www.irs.gov/businesses/article/0,,id=205889,00.html (last visited Oct. 19, 2009). This number does not include U.S. troops stationed abroad.

2 *See generally* Internal Revenue Code (IRC) §§ 1(a), 11(a), 61(a), and 862(a)(5); Treas. Reg. § 1.1-1(b). *See also* IRC §§ 861, 862, 864, 871, 881, and 882.

3 IRS Compliance Data Warehouse, Individual Returns Entity Table, Tax Year 2007. Some taxpayers living overseas may have filed using a domestic (U.S.) address or not have had a filing obligation because their income fell below the filing threshold. The IRS currently does not have the means to identify any overseas residents from the tax return filings of taxpayers showing a domestic (U.S.) address.

About 240,000[4] U.S. small businesses engaging in economic activity abroad must cope with additional complexity, including:

- Deferral of blocked foreign income reporting;[5] and
- Access to pre-filing and advance pricing agreements for an affordable fee.[6]

Many taxpayers also remain confused about mandatory self-reporting on foreign financial accounts, which is required even if no tax is due.[7] For these taxpayers, even inadvertent noncompliance may result in steep penalties.[8]

U.S. taxpayers located or conducting business abroad need efficient and accessible taxpayer service as close to their country of residence as possible. Yet the IRS has decreased the number of overseas posts devoted to taxpayer service from 15 to four since the 1980s, providing substantially fewer resources to this group of taxpayers than it offers to their domestic counterparts.[9]

ANALYSIS OF PROBLEM

Background

Globalization increasingly affects U.S. taxpayers, as a growing number live and conduct business abroad. The IRS estimates the number of U.S. citizens residing outside the country at about seven million.[10] Individual U.S. taxpayers living abroad reported approximately $36.7 billion in foreign-earned income in tax year 2006.[11] At the same time, 239,287 small businesses were involved in export activities.[12] These companies made up 97.3 percent of all known exporters, and they engaged in approximately $260 billion in known export transactions – 28.9 percent of the total.[13]

4 U.S. Census Bureau, *Profile of U.S. Exporting Companies 2006-2007* (Apr. 9, 2009).

5 Income from countries with restrictions on converting local currency into U.S. dollars is called "blocked" income.

6 Pre-filing agreements encourage taxpayers to request consideration of an issue before the tax return is filed and thus, resolve potential disputes and controversy earlier in the examination process. Advance pricing agreements generally provide certainty to taxpayers that the income associated with the covered transactions will not be subject to double taxation by both the U.S. and the foreign jurisdiction.

7 Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts* (Oct. 2008).

8 For example, the maximum fine for non-willful failure to report a foreign bank account (FBAR) is $10,000 per violation. *See generally* 31 U.S.C. § 5321(a)(5); 31 C.F.R. § 103.57(g).

9 Large and Mid-Size Business (LMSB) division response to TAS research request (Sept. 18, 2009).

10 *See* IRS, *Reaching Out to Americans Abroad* (Apr. 2009), http://www.irs.gov/businesses/article/0,,id=205889,00.html (last visited Oct. 19, 2009). This number does not include U.S. troops stationed abroad.

11 IRS Pub. 1136, *Statistics of Income Spring Bulletin* (Mar. 2009).

12 U.S. Census Bureau, *Profile of U.S. Exporting Companies 2006-2007* (Apr. 9, 2009).

13 *Id. See also* Chad Moutray, *Looking Ahead: Opportunities and Challenges for Entrepreneurship and Small Business Owners* 9, U.S. Small Business Administration, Office of Advocacy (Oct. 2008).

Tax Issues Facing Individual U.S. Taxpayers Living Abroad

Lack of Awareness of Return Filing Obligations May Contribute to Low Filing Rate

It appears that not all U.S. taxpayers overseas are aware of the requirement to file a return.[14] As noted above, of the estimated seven million U.S. citizens located abroad, only about 6.6 percent filed U.S. tax returns from a foreign address in TY 2007.[15]

By not filing tax returns, many of these taxpayers may be forfeiting significant tax benefits. Qualifying U.S. citizens and resident aliens who live and work abroad may be able to exclude amounts received as compensation for their personal services.[16] They may also qualify to exclude or deduct certain foreign housing costs.[17] However, the foreign earned income and foreign housing exclusions are not automatic, *i.e.*, a taxpayer must file an election to receive such exclusions or deductions.[18]

U.S. taxpayers who do not elect these exclusions within certain prescribed periods may only elect to do so later if they do not owe federal income tax after the exclusions are taken into account.[19] If after the prescribed periods have passed, the IRS discovers that the foreign earned income and housing cost exclusions would not have fully eliminated the taxpayer's U.S. tax liability, his or her only recourse is to seek relief by means of a private letter ruling, which may be costly.[20] Taxpayers who do not timely file an election to exclude foreign earned income or foreign housing amounts may also be subject to penalties and interest.

Decreased IRS Overseas Presence

The IRS provides in-person return preparation assistance to domestic low income taxpayers through a network of Taxpayer Assistance Centers (TACs). In addition, the IRS Nationwide Tax Forums offer case resolution services to tax professionals and their clients in several American cities each year. However, the IRS does not provide similar services overseas. Many U.S. citizens abroad may either be unaware of the Tax Forums or unable to participate because of geographical location or cost of travel.

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14 While the IRS reasonably assumes that some taxpayers may be consciously trying to avoid their U.S. tax obligations, the National Taxpayer Advocate believes that most taxpayers are law-abiding and simply do not understand what they are required to do or the tax benefits they may be forfeiting because of the complexity of multinational filing and payment requirements.

15 IRS Compliance Data Warehouse, Individual Returns Entity Table, Tax Year (TY) 2007.

16 IRC § 911(b)(2)(D). In tax year 2008, the indexed-for-inflation foreign earned income exclusion was $87,600; in 2009 it is $91,400. Rev. Proc. 2008-66, § 3.28, 2008-2 C.B. 1107.

17 IRC § 911(c) and (d). Housing expenses were generally limited to $26,280 in 2008.

18 A taxpayer must make an election by completing the appropriate parts of Form 2555 or Form 2555-EZ separately for the foreign earned income exclusion and the foreign housing exclusion and attaching the forms to a timely filed return (including any extensions), a return amending a timely filed return, or a late-filed return filed within one year from the original due date of the return (determined without regard to any extensions). Treas. Reg. § 1.911-7.

19 Only about 335,000 taxpayers claimed the foreign earned income exclusion, housing exclusion, or housing deduction in tax year 2006. IRS Pub. 1136, *Statistics of Income Spring Bulletin* (Mar. 2009). Even taxpayers owing tax after taking into account the exclusion may still choose the exclusion on a belated return before the IRS discovers that the taxpayer failed to choose the exclusion. Treas. Reg. § 1.911-7(a)(2)(i)(D).

20 Private letter rulings may cost up to $11,500 per ruling request. Treas. Reg. § 301.9100-1; Rev. Proc. 2009-1, 2009-1 C.B. 1.

The IRS does maintain overseas posts devoted to taxpayer service, but has decreased the number of tax attaché posts in foreign cities from 15 to four.[21] For example, in 2003 the IRS closed the tax attaché post in Mexico City and relocated it to Plantation, Florida, depriving over one million U.S. citizens residing in Mexico of in-country taxpayer service.[22]

The four remaining attachés conduct regular outreach to American citizens and organizations overseas, but the IRS does not track this outreach or record the number of participants at each venue.[23] Moreover, the tax attachés mainly focus on examinations and the exchange of information with foreign governments; only a limited number of attaché employees are assigned to taxpayer service.[24] The IRS has also suspended overseas assistance tours at U.S. embassies because these tours were not cost-effective and "minimal in relation to the number of taxpayers living abroad."[25] While the IRS plans to add ten additional tax attaché positions at various foreign locations to assist with criminal investigations, it does not intend to increase the resources allocated to taxpayer service in any of the top ten foreign countries where Americans reside, as shown in the table below.[26]

TABLE 1.7.1, Ten Top Countries Where Americans Reside Outside the U.S.[27]

Country	U.S. Citizens Residing	IRS Post	Customer Service Employees
Mexico	1,036,300	No	0
Canada	687,700	No	0
United Kingdom	224,000	Yes	4
Germany	210,880	Yes	2
Italy	168,967	No	0
Philippines	105,000	No	0
Australia	102,800	No	0
France	101,750	Yes	2
Israel	94,195	No	0
Spain	94,513	No	0

21 The IRS posts are located in Frankfurt, London, Paris, and Beijing. *See* Internal Revenue Manual (IRM) 4.30.3 (Sept. 12, 2006). Since the 1980s, the IRS has steadily reduced its civil tax presence overseas to save on security, construction, and maintenance costs. *See* LMSB response to TAS research request (Sept. 18, 2009).

22 LMSB response to TAS research requests (July 20, 2009, and Sept. 18, 2009). The Plantation post serves 45 jurisdictions in Latin American and the Caribbean, including Mexico. IRM 4.30.3.3 (Sept. 12, 2006).

23 LMSB response to TAS research request (July 20, 2009).

24 *See* IRS Today Vol. 4 No.1 (Jan./Feb. 2008), *A Day in the Life of the Paris Tax Attaché*, http://communications.no.irs.gov/ProductIndex/IRSToday/IRST200801/story10.asp (last visited Aug. 8, 2008); LMSB response to TAS research request (July 15, 2008). The London office has four Taxpayer Service Specialists, while both the Frankfurt and Paris offices have two Taxpayer Service Specialists.

25 During the last overseas assistance tour from February 28 to March 31, 2008, IRS employees provided face-to-face assistance to 2,603 individuals at 21 U.S. embassies, spending approximately four days at each location. In 2007, W&I assisted 2,090 individuals at 25 locations. W&I responses to TAS research request (Oct. 14 and 19, 2009).

26 The IRS Criminal Investigation function (CI) currently has eight attachés in London, Ottawa, Frankfurt, Hong Kong, Barbados, Mexico City, Bogota, and Baghdad. In fiscal year (FY) 2010, CI is hiring and adding seven attachés to existing posts and hiring three new attachés to the three new posts, going from eight current attaches to a total of 18 attachés. CI response to TAS research request (Aug. 7, 2009).

27 *See* General Services Administration, *Federal Citizen Information Center, at* http://www.pueblo.gsa.gov/cic_text/state/amcit_numbers.html (last visited Oct. 19, 2009).

The Complexity of Foreign Tax Credit Rules and Limitations

Generally, U.S. citizens living abroad can take either a credit or a deduction for foreign taxes paid or accrued on income (including foreign taxes paid in lieu of a tax on income) that exceed the amount of the foreign earned income exclusion.[28] Taxpayers who claim the foreign tax credit (FTC) must complete Form 1116, *Foreign Tax Credit*.

The FTC is a highly sophisticated and complex mechanism, containing detailed and complicated provisions.[29] Individual U.S. taxpayers abroad may not have the resources to fully comply with them.[30] The IRS does not have an easily accessible interactive FTC calculator on its website. In addition, inflation has eroded the value of the $300 ($600 if filing a joint return) creditable foreign taxes on qualified passive income limitation, which has not been adjusted since 1997.[31] More taxpayers are being exposed to this limitation as a result of falling dollar exchange rates and increased investments in mutual funds in other countries.[32]

International Tax Treaties

The United States has bilateral income tax treaties with 66 countries, which provide for reduced rates of tax or exemptions from U.S. or foreign tax on certain items of income from sources within the United States or the treaty partner.[33] For example, distributions from a foreign pension plan, unlike distributions from a U.S. qualified plan, generally are fully taxable to a U.S. citizen recipient unless a tax treaty provides an exclusion.[34] To claim treaty benefits, the taxpayer must attach a fully completed Form 8833, *Treaty-Based Return Position Disclosure*, to his or her return.[35] Each treaty may provide for different treatment of various items of income, increasing the complexity for those persons entitled to claim benefits under more than one treaty.

The IRS has a pre-filing agreement program that encourages taxpayers to request consideration of an issue before the tax return is filed and thus, resolve potential disputes and

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28 IRC §§ 901 and 903. *See also* IRS Pub. 514, *Foreign Tax Credit for Individuals* (2008).

29 *See generally* IRC § 904. For example, the IRS.gov website refers to the downloadable Pub. 514, *Foreign Tax Credit for Individuals*, which is 44 pages long and contains cross-references two other publications comprising about 145 more pages.

30 The cost of taxpayer compliance with the international rules is proportionately much higher than for domestic rules. American Bar Association (ABA), *Report of the Task Force on International Tax Reform*, 59 Tax Lawyer 649, 717 (2006).

31 IRC § 904(k)(2)(B) and (3)(A); Treas. Reg. § 1.904(j)-1(b)(3). This provision was added by the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (1997). Inflation adjusted value of the limitation in 2009 is $404.07 ($808.14 for jointly filed returns). U.S. Bureau of Labor Statistics, Inflation Calculator, http://data.bls.gov/cgi-bin/cpicalc.pl (last visited Oct. 6, 2009). *See also* Legislative Recommendation: *Increase the Threshold for the Election to Claim the Foreign Tax Credit Without Filing Form 1116 for Individuals and Index It for Inflation, infra.*

32 Systemic Advocacy Management System (SAMS) Issue No. 16051 (Sept. 16, 2009).

33 IRS, *Tax Treaties*, http://www.irs.gov/businesses/international/article/0,,id=96739,00.html (last visited Oct. 19, 2009).

34 IRC §§ 72, 1441, 3405. *See, e.g.*, the USA-Canada treaty. The IRS website instructs elderly U.S. retirees living abroad to study an overwhelming amount of information, including six IRS publications totaling 417 pages. The website refers to IRS Pub. 575, *Pension and Annuity Income*; IRS Pub. 939, *General Rule for Pensions and Annuities*; IRS Pub. 590, *Individual Retirement Arrangements (IRAs)*; IRS Pub. 519, *U.S. Tax Guide for Aliens*; IRS Pub. 515, *Withholding of Tax on Nonresident Aliens and Foreign Entities*; IRS Pub. 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad.* *See* IRS, *The Taxation of Foreign Pensions and Annuity Distributions*, http://www.irs.gov/businesses/article/0,,id=187083,00.html (last visited Oct. 19, 2009).

35 Exceptions to this requirement for certain types of income are outlined in IRS Pub. 519, *U.S. Tax Guide for Aliens*.

controversy earlier in the examination process. The program reduces costs and burden associated with the post-filing examination by providing a level of certainty regarding a specific issue or transaction. However, this program is limited to LMSB taxpayers.[36] The IRS should consider clarifying international tax treaty issues for individual U.S. taxpayers abroad by extending its pre-filing agreement program to individuals. Such action may significantly reduce the number of invalid positions taken by taxpayers on Forms 8833. The IRS should also publish an annual list of jurisdictions and the taxability of pensions, annuities, or Social Security payments in these jurisdictions under the tax treaties the United States has with these countries.

Foreign Currency and Currency Exchange Rates

For a U.S. taxpayer living abroad, the measurement of income may be complicated if he or she is paid in foreign currency. Even in the simplest case, income and deductible expenses denominated in foreign currency must be translated into U.S. dollars contemporaneously, using the prevailing exchange rate when the items of income or expense are paid, received, or accrued.[37] For taxpayers already confused by the multitude of available rates, the IRS website recommends "us[ing] the one that most properly reflects your income," without further explanation.[38] In some cases, gain or loss can be triggered simply by changes in foreign currency values, which do not represent an actual or economic gain or loss for the taxpayer not involved in the currency exchange business.[39]

Even though individual U.S. taxpayers abroad cannot choose a foreign currency as their functional currency,[40] the IRS should provide these taxpayers with an easy online tool to determine and print the official exchange rates they should use for translating their income and expense items into the U.S. dollar.[41]

36 Rev. Proc. 2009-14, 2009-1 C.B. 324.

37 IRC § 985. For all individual U.S. taxpayers the functional currency is the U.S. dollar except for some qualified business units. There may be more than one exchange rate, and the IRS recommends these taxpayers obtain rates from banks and U.S. embassies. IRS, *Foreign Currency and Currency Exchange Rates*, http://www.irs.gov/businesses/small/article/0,,id=130524,00.html (last visited Oct. 19, 2009).

38 IRS, *Foreign Currency and Currency Exchange Rates*, http://www.irs.gov/businesses/small/article/0,,id=130524,00.html (last visited Oct. 19, 2009).

39 IRC § 988. *See also* Andy Sundberg, *Citizenship-Based Taxation Is an Experiment that Is Doomed to Keep Running Aground on the Reefs of Complexity, Inequity and an Unlevel Playing Field*, Submission to the President's Advisory Panel on Federal Tax Reform (Mar. 9, 2005).

40 *See generally* IRC § 985.

41 The IRS website does contain a link to an external site (www.oanda.com) that provides 11 different types of rates (and three additional sub-rates within these rates), but the IRS should consider developing a less complex tool hosted on its own website (www.iRS.gov). *See* http://www.irs.gov/businesses/small/international/article/0,,id=97324,00.html (last visited Nov. 5, 2009). Another approach is to allow U.S. taxpayers permanently residing abroad to substantiate all their income and expense items in the currency of the countries where they live and then translate the final calculation into the U.S. dollar at an annual exchange rate published by the IRS.

Tax Problems Affecting U.S. Small Businesses Involved in Economic Activity Overseas

Small businesses in general face disproportionately higher compliance costs per employee than their larger counterparts.[42] The complexity and administrative detail of the international tax rules add to the procedural burden placed on the approximately 240,000 U.S. small businesses involved in economic activity overseas.[43]

An example of procedural burden faced by U.S. citizens who conduct business through a foreign corporation that they significantly own or control is Form 5471, *Information Return of U.S. Person With Respect to Certain Foreign Corporations* (Dec. 2007).[44] Form 5471 is four pages long, not including Schedules J, M, and O. The instructions are 16 pages long. According to the IRS's own estimates, a small business taxpayer might easily need three work weeks to complete and file this form![45]

A 2004 Small Business Administration study reported that the inability of small businesses to fully comprehend the complex international tax rules, or to obtain costly legal representation to reduce their U.S. tax liabilities, may have contributed to small firms with less than $10 million in revenues not realizing the full benefits of the FTC.[46] The IRS does not have a comprehensive outreach strategy specifically targeting small businesses with international features.[47] In the absence of a targeted, systemic IRS approach to education and outreach, this taxpayer population, representing 97 percent of U.S. exporters, faces significant difficulties in understanding international tax law and complying with tax obligations.

The IRS Should Simplify Procedures for Deferral of Blocked Foreign Income Reporting

A U.S. taxpayer living or operating business in a country with restrictions that prevent him or her from converting local currency into U.S. dollars, or into other money or property readily convertible into dollars, may postpone reporting such income until it becomes

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42 Chad Moutray, *Looking Ahead: Opportunities and Challenges for Entrepreneurship and Small Business Owners* 3, U.S. Small Business Administration, Office of Advocacy (Oct. 2008).

43 U.S. Census Bureau, *Profile of U.S. Exporting Companies 2006-2007* (Apr. 9, 2009). There are 43 IRS publications that are related to U.S. small businesses involved in economic activity abroad, totaling 1,212 pages. These publications refer to additional publications totaling 13,346 pages, 1,500 pages of forms, and another 5,018 pages of form instructions.

44 *See generally* IRC §§ 951-965 (addressing the taxation of shareholders of Controlled Foreign Corporations (CFCs)).

45 *See* instructions to IRS Form 5471 (2008). The estimated burden for those filing this form is 82 hours, 45 minutes for recordkeeping, 16 hours, 14 minutes for learning about the law or the form, and 24 hours, 17 minutes for preparing and sending the form to the IRS. The total burden sums up to 123 hours and 16 minutes, or 15.375 eight-hour work days.

46 Innovation Information Consultants, Inc. (study for U.S. Small Business Administration), *The Impact of Tax Expenditure Policies on Incorporated Small Businesses 4 (Apr. 2004).* For example, the study reports that small businesses realize reduction in the effective tax rate of approximately 0.13 percent, compared to large firms that receive a reduction of 2.2 percent.

47 Small Business/Self-Employed (SB/SE) division response to TAS research request (Aug. 18, 2009). This term includes U.S. taxpayers with assets of $10 million or less and located abroad or engaged in foreign economic activity.

unblocked.[48] This is accomplished by filing an "information return" with the tax return – a second Form 1040 that is attached to the primary return and is labeled *Report of Deferrable Foreign Income*. Such returns cannot be filed electronically. Moreover, if the taxpayer has blocked income from more than one country, the taxpayer must file a separate information return for each country. In addition, if a taxpayer has failed to file an information return exactly as prescribed in the revenue ruling, the blocked foreign income is taxed in the year it is received.[49] Thus, for a taxpayer with blocked income in more than one foreign country, the procedures for deferring the income can be very burdensome.[50]

If, after treating income as blocked, a taxpayer wishes to change its reporting position and include the previously deferred blocked foreign income, he or she must secure the consent of the Commissioner by filing Form 3115, *Application for Change in Accounting Method*.[51] Such a requirement is burdensome for taxpayers and does not serve the best interests of the government, which may otherwise receive additional revenue from the inclusion of blocked foreign income if a taxpayer chooses not to postpone the reporting of such income until it becomes unblocked.

The IRS needs to simplify the procedure for deferral of blocked foreign income reporting by eliminating the requirement to file an "information return" on a Form 1040 (or multiple Forms 1040) and the requirement to file Form 3115 if a taxpayer wishes to include blocked income in gross income although the income is still blocked.[52] The IRS should include a checkbox on the Form 1040 reflecting that the taxpayer is postponing the reporting of the income and add lines where the taxpayer can report the country (or countries) and amount(s) of foreign income being deferred. The IRS should also allow electronic filing for taxpayers with blocked foreign income and prominently display the information about deferring blocked foreign income on its website.[53]

48 Rev. Rul. 74-351, 1974-2 C.B. 144, *modified by* Rev. Rul. 81-290, 1981-2 C.B. 108. In this regard, Rev. Rul. 74-351 allows a taxpayer to elect, pursuant to IRC § 446, to use a method of accounting in which the reporting of the blocked income as taxable income is deferred. However, income is unblocked if it is used for personal expenses, or disposed of by gift, bequest, or devise. For the purposes of this discussion, we do not address the treatment of blocked earnings and profits of a CFC under IRC § 964(b), Treas. Reg. § 1.964-2.

49 *Berman v. Comm'r*, T.C. Memo. 1983-214 (noting that the deferral is a privilege conditioned on adherence to the prescribed procedures).

50 According to the International Monetary Fund (IMF) report, 35 countries maintained currency exchange restrictions as of December 31, 2007. *See* IMF, Annual Report on Exchange Arrangements and Exchange Restrictions 2008, 28. *See also* Table 6, *Type of Exchange Restrictions*, 2007, and Table 7, *Types of Restrictions and/or Multiple Currency Practices Maintained by Countries*, December 31, 2007. IMF Report, 27, 29.

51 Revenue Ruling 81-290 modified question 3 of Revenue Ruling 74-351 to require taxpayers to obtain the consent of the Commissioner to change from either the deferred or nondeferred method of accounting in a year subsequent to the year of the initial reporting of blocked foreign income. Rev. Rul. 81-290, 1981-2 C.B. 108, *modifying* Rev. Rul. 74-351, 1974-2 C.B. 144.

52 Alternatively, the Commissioner's consent might be automatically given to such proposed changes. On September 15, 2009, the National Taxpayer Advocate submitted recommendations for published guidance regarding deferral of blocked foreign income reporting to the IRS Office of Chief Counsel for inclusion in the 2009-2010 Priority Guidance Plan.

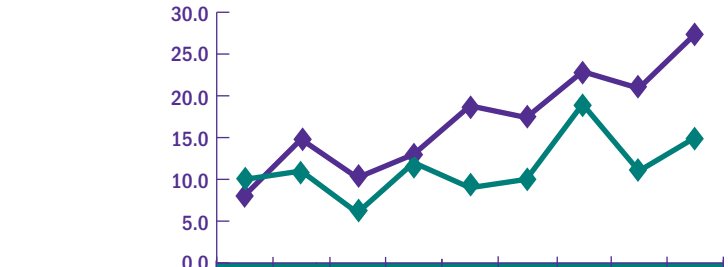
53 By eliminating the requirement to file the "information return" on a Form 1040 (or multiple Forms 1040), taxpayers would no longer be precluded from filing electronically solely because they reside in a country with restrictions on converting currency into U.S. dollars.

U.S. Small Businesses Engaged in International Economic Activity Need Access to Pre-filing and Advance Pricing Agreements for an Affordable Fee.

Small business taxpayers do not possess the financial resources and sophistication to deal with the complexity of the international tax rules. However, the IRS does little to accommodate these taxpayers. For example, U.S. small businesses abroad are not eligible to participate in the pre-filing agreement program.[54]

The advance pricing agreement (APA) program is available to U.S. small businesses abroad.[55] However, the $22,500 user fee can make it cost-prohibitive for many. Chart 1.7.2 below illustrates the number of completed small business APAs and the average completion time for these APAs in tax years 2000-2008.

CHART 1.7.2, Small Business Advance Pricing Agreements in TY 2000-2008[56]



	2000	2001	2002	2003	2004	2005	2006	2007	2008
SB APAs Completed	10	11	6	12	9	10	19	11	15
Average Months	8.1	14.8	10.2	13.0	18.8	17.4	22.9	20.9	27.4

The chart shows that while the number of small business APAs ranged from ten in TY 2000 to the maximum of 19 in TY 2006, the processing time steadily increased from an average of 8.1 months in TY 2000 to over 27 months in TY 2008.[57] The National Taxpayer Advocate is concerned that the IRS does not have a comprehensive strategy specifically addressing the international tax issues facing the small business taxpayer.[58] The IRS should develop new flexible pre-filing and advance pricing agreement rules specifically

54 Rev. Proc. 2009-14, 2009-13 C.B. 324.

55 The APA program generally benefits taxpayers by providing certainty that the income associated with the covered transactions will not be subject to double taxation by both the U.S. and the foreign jurisdiction. *See generally* IRC § 482.

56 Annual APA Statutory Reports, http://www.irs.gov/businesses/corporations/article/0,,id=96191,00.html (last visited Oct. 19, 2009).

57 Given the number of processed small business APAs from TY 2000 to TY 2008, the APA program was largely underutilized by the small business community, most likely because of excessive user fees.

58 The IRS does not specifically track or provide outreach to U.S. small businesses with international features. Teleconference with SB/SE subject matter expert (June 29, 2009). LMSB response to TAS research request (July 20, 2009).

addressing U.S. small businesses located or engaged in economic activity overseas, with reduced, affordable user fees for these taxpayers.[59]

Mandatory Self-Reporting on Foreign Financial Accounts

A U.S. person with a financial interest in or signatory authority over financial accounts in a foreign country with an aggregate value exceeding $10,000 at any time during the taxable year must file Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts* (Oct. 2008) (known as FBAR), with the IRS on or before June 30th the following year, even if no tax is due.[60] Failure to file an FBAR form timely and voluntarily may result in steep penalties.[61] These penalties are not subject to U.S. Tax Court jurisdiction[62] and not dischargeable in bankruptcy.[63] Table 1.7.3 below shows the number of FBAR Forms TD F 90-22.1 filed, penalties assessed, and criminal charges filed in calendar years 2004-2008.

59 For example, Canada Revenue Agency established a reduced fixed fee of $5,000 (Canadian) for small businesses participating in its APA program. Shiraj Keshvani, *Canada's APA Program*, presentation at the ABA Section of Taxation 2009 Joint Fall CLE Meeting, Chicago, IL (Sept. 25, 2009). *See also* 31 U.S.C. § 9701; Office of Management and Budget, Circular A-25, 58 Fed. Reg. 38,142 (July 15, 1993); National Taxpayer Advocate 2007 Annual Report to Congress 66 (Most Serious Problem: *User Fees: Taxpayer Service for Sale*).

60 31 U.S.C. § 5314(a) and 5321; 31 C.F.R. §§ 103.24, 103.27, 103.32, and § 103.57, and subparts F and G; 31 C.F.R. parts 5 and 900. This date cannot be extended and the form must be filed on paper. The FBAR filing requirement is separate from the taxpayer's obligation to indicate whether the individual has an interest in a financial account in a foreign country by checking "Yes" or "No" in the appropriate box on Schedule B of the federal tax return. *See* Form 1040, Schedule B (2008). Recently, the IRS established the Office of Fraud/BSA, which reports directly to the Commissioner of the SB/SE division specifically for monitoring FBAR compliance.

61 For example, the maximum fine for non-willful failure to report a foreign bank account is $10,000 per violation, while penalties for willful failure to report a foreign bank account can range from the greater of 50 percent of the amount in the account at the time of the violation or $100,000, even if the account does not generate taxable income. Criminal penalties for violating the FBAR requirements while also violating certain other laws can range up to a $500,000 fine or ten years imprisonment or both. *See* 31 U.S.C. § 5321(a)(5); 31 C.F.R. § 103.57(g) (civil penalties); 31 U.S.C. § 5322(a) and 31 C.F.R. § 103.59(b) (criminal penalties).

62 *See Williams v. Comm'r*, 131 T.C. No. 6 (2008) (holding that the U.S. Tax Court lacks jurisdiction to review the Secretary of Treasury's determination as to taxpayer's liability for FBAR penalties). For a more detailed discussion of this case, see *Significant Cases, infra*.

63 *See U.S. v. Simonelli*, 102 A.F.T.R.2d (RIA) 6577 (D. Conn. 2008) (foreign bank account holder's debt for penalty for failure to file FBAR report was for a "civil money penalty" and not a "tax", and so excepted from discharge under the Bankruptcy Code).

TABLE 1.7.3, FBAR Filings in Calendar Years (CY) 2004-2008[64]

Type	Number of FBAR Forms TD F 90-22.1 filed				
	2004	2005	2006	2007	2008
Individuals	253,696	265,272	288,014	305,181	204,799
Partnerships	5,120	6,170	7,433	8,384	3,960
Corporations	16,234	18,183	19,536	20,519	7,884
Fiduciaries	1,854	1,946	2,080	2,335	2,197
	FBAR penalties assessed				
	2004	2005	2006	2007	2008
Individuals	64	115	103	64	31
Partnerships	0	0	0	0	0
Corporations	1	2	12	0	11
Fiduciaries	0	0	2	0	0
	Criminal FBAR charges filed*				
	2004	2005	2006	2007	2008
Individuals	17	18	12	6	6
Partnerships	0	0	0	0	0
Corporations	1	0	0	1	0
Fiduciaries	0	0	0	0	0

* Information provided by Criminal Investigation function.

Lack of Clear FBAR Definitions and Filing Deadlines

At least one commentator has complained that certain new FBAR reporting rules recently published by the IRS have "not rectified the ambiguities in the hodgepodge of incongruous definitions and use of tax terms of art without definition."[65] According to the New York State Bar Association, the FBAR guidance process is very confusing and informal, with often conflicting information scattered through the IRS website, requiring taxpayers and practitioners to engage in a "scavenger hunt to find relevant information with no guarantee that the information will not be "reviewed or updated" the next day on the website."[66] Nonetheless, unlike other IRS form instructions, FBAR reporting instructions may carry the force of law.[67]

64 SB/SE response to TAS research request (Oct. 15, 2009). CY 2008 data include data through October 6, 2009. FBAR filings are reflected in the year in which they are filed, not actually posted. The Office of Fraud/BSA generally reports filings by year posted.

65 Joseph M. Erwin, *The New and Improved FBAR: Broader in Scope with Enhanced Enforcement but Not More Clarity*, The Texas Tax Lawyer, vol. 36, No. 3, 45-53, 51 (May 2009). Some practitioners do not agree with the IRS's authority to promulgate FBAR rules through web postings and changes in the instructions to Form TD F 90-22.1.

66 New York State Bar Association, *Request for Formal Guidance on FBAR Reporting Obligations*, letter to the Treasury and the IRS, 7, n.16 (July 17, 2009) (referring to often overlapping and conflicting FBAR FAQs posted on IRS website in different stand-alone versions on June 23, June 24, and "reviewed and updated" on July 14, 2009).

67 In *U.S. v. Clines*, 958 F.2d 578 (4th Cir. 1992), *cert. denied*, 505 U.S. 1205 (1992), the United States Court of Appeals for the Fourth Circuit applied definitions in the instructions to the FBAR form to uphold a conviction for failing to file the report.

The National Taxpayer Advocate is concerned about the ambiguity and frequent changes of FBAR definitions and filing deadlines in the instructions and website releases.[68] The IRS should provide clearer definitions and definite filing deadlines through Title 31 regulations to avoid potential challenges of these regulatory deficiencies by practitioners as a result of the enhanced enforcement efforts.[69] The IRS should also consider creating an easy-to-follow, secure online application to allow taxpayers to file TD F 90-22.1 electronically.

Determining the Maximum and Aggregate Value of the Foreign Financial Accounts

In October 2008, the IRS revised Form TD F 90-22.1, which now requires the taxpayer to provide the exact *maximum* value of the account in U.S. dollars during the calendar year being reported instead of a range as on prior versions of the form.[70] However, when the account is denominated in foreign currency, the taxpayer is instructed to use the official exchange rate at the end of the year. Given the volatility of exchange rates, the maximum value in U.S. dollars may be different at the time of the maximum balance on the account and at the end of the year. U.S. citizens abroad are concerned about the inherent ambiguity in these instructions and are confused about what exchange rate to use – the one for the date of the maximum balance on the account or the rate of exchange on the last day of the year.[71] It is also unclear what exchange rate taxpayers should use to calculate the maximum aggregate value of all foreign financial accounts *at any time* during the taxable year.

It would make sense for the form to require reporting in the currency of the account. In the alternative, the IRS could require taxpayers to provide the maximum value of the account in the currency of the account at any time during the year, and then use the exchange rate for that day to determine whether they need to file the FBAR form. The IRS should post currency exchange rates prominently on its website to avoid taxpayer confusion with the multitude and volatility of the rates.[72]

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68 *E.g.*, in 2009 the IRS posted at least three different deadlines for FBAR filing, confusing taxpayers and even seasoned tax practitioners. First, the IRS stated that taxpayers must file the form by mailing on or before June 30 and that this deadline could not be extended. *See* IRS, *FAQs Regarding Report of Foreign Bank and Financial Accounts (FBAR) - Filing Requirements*, Q8 (June 29, 2009), http://www.irs.gov/businesses/small/article/0,,id=210244,00.html#FR8 (last visited Oct. 19, 2009); Instructions to Form TD F 90-22.1 (Oct. 2008). At about the same time, on June 24, 2009, the IRS posted a release extending FBAR filing deadline until September 23, 2009. *See* IRS, *September 23 Deadline for Some FBAR Filers*, http://www.irs.gov/newsroom/article/0,,id=210174,00.html (last visited Oct. 19, 2009). Finally, on Sept. 21, 2009, the IRS announced a "one time" extension of deadline until Oct. 15, 2009. *See* IR-2009-84. *See also* Joseph M. Erwin, The New and Improved FBAR: Broader in Scope with Enhanced Enforcement But Not More Clarity, The Texas Tax Lawyer, vol. 36, No. 3, 45-53 (May 2009); New York State Bar Association, Request for Formal Guidance on FBAR Reporting Obligations, letter to the Treasury and the IRS (July 17, 2009).

69 The delegation of authority from FinCEN specifically authorizes the IRS to "issue administrative rulings under 31 C.F.R. Part 103, Subpart G." *See* 31 C.F.R. §§ 103.85; 103.81. However, the IRS narrowly interprets that it may not issue public guidance besides revising FBAR form instructions and publishing outreach materials and notices on IRS website. If this is the case, the IRS needs to revisit the delegation of authority so that it permits the IRS to issue published guidance in the formats it does use under Title 26.

70 Form TD F 90.22.1, *Report of Foreign Bank and Financial Accounts* (Oct. 2008), General Instructions, 7-8. The maximum value of an account is the largest amount of currency or non-monetary assets that appear on any quarterly or more frequent account statement issued for the applicable year.

71 Jackie Bugnion, Director, Association of American Citizens Abroad, *Concerns: TD F 90-22.1 Report of Foreign Bank and Financial Accounts*, letter to TAS (June 17, 2009) (on file with the National Taxpayer Advocate).

72 For example, one of the external websites dealing with foreign currency exchange rates provides 11 different types of rates and three additional sub-rates within these rates. *See* www.oanda.com (last visited Sept. 21, 2009).

Signatory Authority but No Personal Financial Interest and Duplicate Filing Requirements

The rules may also require some taxpayers to file FBAR reports even when they are not authorized to provide the information the reports require. For example, American taxpayers who work for foreign corporations or serve on the boards of foreign charitable organizations and have no financial interest over the organizations' accounts may have trouble securing information for the FBAR report.[73] These foreign entities may simply refuse to authorize the American employee to provide the account information to the IRS, placing the taxpayer in a difficult situation.[74] In addition, under current rules multiple persons may have FBAR filing requirements for the very same account, resulting in duplicate filings for such account. The IRS might need to consider revising FBAR form instructions to exclude individuals who have signature authority over a foreign financial account for which a person with a financial interest in that account is not required to file an FBAR, or for which another person with an FBAR filing requirement who has a financial interest in the account has notified such individual in writing that an FBAR has been filed.

CONCLUSION

The National Taxpayer Advocate is concerned about the IRS's insufficient focus on tax problems facing U.S. citizens abroad. As a result, these taxpayers are at a clear disadvantage compared to their counterparts located in the United States. The National Taxpayer Advocate also believes U.S. small businesses involved in economic activity abroad deserve the same level of certainty about their tax obligations as large corporate taxpayers.

In conclusion, the National Taxpayer Advocate offers these preliminary recommendations:

1. Develop a comprehensive strategy and outreach materials specifically targeting tax problems facing this taxpayer population;
2. Develop easy to follow and specific guidance for U.S. citizens and small businesses located and conducting business abroad at on the IRS.gov website;
3. Devote more tax attaché posts to taxpayer service;
4. Relocate the tax attaché post responsible for Mexico back to Mexico City;
5. Open case resolution rooms at tax attaché posts and during tax venues abroad;
6. Extend the pre-filing agreement program to individual and small businesses taxpayers abroad;
7. Reduce filing fees for the APA program for small businesses with assets of $10 million or less;

[73] For example, a foreign entity not doing business in the U.S. would have a financial interest in the account but would not be required to file an FBAR.

[74] Jackie Bugnion, Director, Association of American Citizens Abroad, *Concerns: TD F 90-22.1 Report of Foreign Bank and Financial Accounts*, letter to TAS (June 17, 2009) (on file with the National Taxpayer Advocate).

8. Encourage the Department of Treasury to refine FBAR definitions through regulations under Title 31;
9. Allow secure electronic filing of FBAR Form TD F 90-22.1; and
10. Eliminate duplicative reporting of foreign financial accounts on income tax forms and FBAR forms.

IRS COMMENTS

The IRS has developed a comprehensive strategy and outreach materials specifically targeting tax problems facing this taxpayer population.

The following is clipped from the 2008 Taxpayer Assistance Blueprint supplied to Congress:

> The IRS Servicewide International Approach seeks to improve tax administration and deal more effectively with the increased globalization of individual and business structures. The IRS approach to international tax administration includes a strategic goal of improving service options for international/U.S. territories and of striving for burden reduction in international tax law administration. The IRS TSPMO function coordinated with the LMSB Deputy Commissioner (International) in late summer 2007 to ensure integration of the TAB and LMSB International service objectives in the approved Servicewide Strategy, published in October 2007.

A critical part of this strategy is understanding the needs and preferences of U.S. persons abroad. To this end, the IRS recently completed a comprehensive research study that will result in a data driven approach for addressing this issue.

The IRS has conducted focus groups on the needs and preferences of international taxpayers at the 2008 Nationwide Tax Forums. We are also in the process of conducting a survey of international customers to determine the type of tax information they need and the best channels for delivering that information.

The servicewide approach to international tax administration also contains other initiatives to improve taxpayer service to our international customers, including enhancing information on irs.gov, delivering international sessions at the Nationwide Tax Forums, evaluating international tax forms and publications to identify ways to reduce burden for all taxpayers.

The SB/SE division's Communications, Liaison and Disclosure (CLD) Stakeholder Liaison (SL) and Communications functions also support LMSB in efforts to provide outreach and information on tax issues to U.S. taxpayers located or conducting business abroad. The CLD SL function maintains a current Outreach Initiative Database (OID) that contains

information on a variety of topics used by SB/SE, SL for outreach initiatives. Two topics included in the database are specific to taxpayers living abroad:

> Topic 302 on the OID contains information on Departing Aliens Tax Responsibilities. The information contains reference to the Departing Alien Clearance (Sailing Permit) on irs.gov, a drop in article, FAQs, Power Point presentation, Talking Points, and a Toolkit on the Form 1040C, *U.S. Departing Alien Income Tax Return*.

> Topic 50 on the OID contains information on Report of Foreign Bank and Financial Accounts (FBAR) Marketing which contains news release **IR 2009-58**, Outreach Power Point, and a Toolkit.

An Issue Management Resolution System (IMRS) request has been created to develop an outreach presentation for delivery to practitioners to help understand the responsibilities small businesses have in dealing with businesses, independent contractors etc. who are overseas. This effort is in the initial stages.

Even though it is estimated that more than seven million American citizens reside abroad, and only 6.6 percent filed U.S. tax returns from a foreign address in tax year 2007, this does not necessarily mean that U.S. taxpayers living abroad are unaware of their filing obligations, confused by the complexity of international tax law, or overwhelmed by the prospect of figuring out what is required. The magnitude of a problem can not be defined so simply. Nor does the National Taxpayer Advocate cite any research or data to support this assertion.

As an example, some of the seven million may not have a filing requirement, some may be children, some may be pensioners living below the threshold for filing, and some people may not want to file. Even though the IRS has decreased the number of overseas posts from 15 to four since the 1980s, it has not resulted in our providing substantially fewer resources to U.S. taxpayers located or conducting business abroad. The IRS uses multiple delivery methods like ETLA, the Internet (IRS.gov) and phone inquiries to provide information and assistance to taxpayers around the world.

The National Taxpayer Advocate makes ten preliminary recommendations to improve service to our U.S. Taxpayers Located or Conducting Business Abroad. The IRS is taking or has taken the following actions with respect to these recommendations:

Develop a comprehensive strategy and outreach materials specifically targeting tax problems facing this taxpayer population.

The IRS agrees with this recommendation. This strategy is already underway to improve taxpayer service to those taxpayers living abroad. Besides the items listed above, the IRS has planned additional initiatives.

Future efforts include initiatives by the Outreach Technology Team which is exploring ways to work with the LMSB International function to tape two webinars that will focus on

international topics. One hour of the broadcast will focus on general international information and one hour on Form 1040 NR, *Non Resident Alien Income Tax Return*. Additional ideas include online workshops on other international forms and topics, enhancements to IRS.gov, and partnering with other agencies to deliver important tax information to our international customers.

Develop easy-to-follow and specific guidance for U.S. citizens and small businesses located and conducting business abroad at on the IRS.gov website.

We agree on the importance of clear guidance and have recently revised our www.irs.gov page on U.S. Citizens and Resident Aliens Abroad to include more comprehensive tax information for Americans overseas including links to more detailed topics such as the foreign tax credit and foreign earned income exclusion. The IRS.gov website contains a wealth of information for small businesses. The page on "Tax Information for International Businesses" includes information on tax withholding, transfer pricing, tax treaties, essential concepts of international taxation, and competent authority assistance, plus much more.

There are also a myriad of pages dedicated to small businesses that contain information on specific industries and professions such as manufacturing, construction, E-Commerce, Entertainment, and Gas Retailers; information on starting a business; business expenses; an A-Z index for businesses; small business resources; forms and publications for small businesses; and topics specific to international small businesses such as tax withholding on foreign persons, special categories of foreign workers. In addition, the IRS sponsors small business tax workshops, phone forums, and webinars. The workshops are available in person, on DVD, and online in streaming video.

Devote more tax attaché posts to taxpayer service.

We disagree with this recommendation, but agree that the issue of our overseas presence should be reviewed. The overseas posts established by the IRS are not solely devoted to taxpayer service. It is only a part of their mission. The primary mission of Tax Attaché is to be the Commissioner's representative in dealings with other tax administrations. The Tax Attachés also act as the eyes and ears of the IRS overseas, representing the IRS with treaty partners on double tax cases, tax treaty matters, Advanced Pricing Agreements (APAs) and like matters when appropriate. They assist domestic IRS offices in obtaining foreign based information which could be both tax treaty and non treaty related information. They assist with identifying market segments or obtaining information to identify compliance trends and problems. In addition, they assist the Treasury International Tax Counsel when necessary. (IRM 4.30.3 provides information on the duties performed by the Tax Attaché).

The IRS is, however, reviewing its criteria for maintaining an overseas presence since 1995. Given the focus on international tax issues, the IRS is developing new criteria for determining its overseas presence including roles and responsibilities and general workload and

staffing. We are also considering the rising costs to the IRS of maintaining permanent posts of duty abroad, and the possibilities, in view of improved technology and communications, for performing some of the work elsewhere.

Relocate the tax attaché post responsible for Mexico back to Mexico City.

We do not agree that the tax attaché responsible for Mexico should be moved back to Mexico City. Mexico City is designated as a "critical threat" post by the State Department due to the high crime rate and health risks. Those conditions made it difficult to recruit qualified personnel. The Mexico City post had responsibility for IRS activities in Mexico, Central America, South America and the Caribbean, a total of 46 countries. The need for local interaction with Mexican authorities has decreased as the treaty relationship has matured enough to handle most bilateral matters from headquarters. Meanwhile, workload for the Caribbean portion of the region has increased significantly over the years. As expected, a dramatic increase in the number of U.S. initiated exchange of information (EOI) requests for that region from IRS compliance and CI personnel has occurred due to the offshore compliance initiatives and availability of information from the new TIEAs.

The proposal to close the Mexico City post was based on a variety of factors, including current and anticipated workload across the 46 countries, the cost of office space and security needs for overseas employees, time and travel costs, and the ability to provide tax information through alternative channels.

The National Taxpayer Advocate's assertion that one million taxpayers are being deprived of in-country taxpayer service is not accurate. It assumes every taxpayer was in need of, and would have been able to receive, taxpayer service from the tax attaché in Mexico City.

Open case resolution rooms at tax attaché posts and during tax venues abroad.

We agree with this recommendation in principle. However, in the past several years the IRS has found it increasingly difficult to find available space, primarily due to consolidation of embassy personnel around the world. Unfortunately, we do not anticipate this problem abating any time in the near future.

Extend the pre-filing agreement program to individual and small businesses taxpayers abroad.

We disagree with this recommendation. It is not appropriate to use a pre-filing agreement (PFA) to clarify for the taxpayer an issue that has numerous legal complexities. A PFA is generally entered into to resolve, in advance of filing, the determination of facts affecting a tax position on a return, the application of well-established legal principles to known facts, or the methodology used by the taxpayer to determine an appropriate amount of income, deduction, allowance or credit.[75]

[75] Rev. Proc. 2009-14 § 3.03.

There is also an issue concerning cost, for both the taxpayer and the IRS. Currently, the user fee charged to obtain a PFA is $50,000.[76] This cost would be prohibitive for most individuals. In addition, a PFA program for all individuals would require significant additional IRS resources, particularly since we question whether the program could reasonably be limited to just individuals and small businesses abroad.

Reduce filing fees for the APA program for small businesses with assets of $10 million or less.

The APA Program recognizes that the historic number of APAs involving taxpayers with assets of $10 million or less has been small,[77] and it would not object in principle to lowering the user fees for the smallest taxpayers. However, we do not believe that the amount of the user fee for small business taxpayers has been a significant reason for the number of APAs filed by smaller taxpayers. Equally important, any effort that is effective in increasing the number of small business taxpayer APAs should not be made without also considering the potential effect that the increase could have on the APA program, including increased resource needs and increased case processing times.

Encourage the Department of Treasury to refine FBAR definitions through regulations under Title 31.

The IRS and the Department of Treasury Financial Crimes Enforcement Network are currently working together to develop published guidance as well as revised FBAR form instructions.

Allow secure electronic filing of FBAR Form TD F 90-22.1.

We recognize the value of allowing secure electronic filing of the FBAR form and have held periodic discussions with FinCEN concerning the eventual implementation. FinCEN currently administers the program for the electronic filing of Title 31 Bank Secrecy Act (BSA) documents through their contract with Northrop-Grumman.

The IRS previously determined not to pursue electronic filing for the FBAR form immediately for two reasons. First, the volume of FBAR forms is relatively low compared to other BSA forms. Electronic filing would not provide the cost benefits derived from the electronic filing of more common income tax forms. Second, it was uncertain at the time, based on draft legislation, whether FBAR would remain a Title 31 filing requirement or become a Title 26 filing requirement. This issue must be decided before any electronic filing program can be developed.

[76] Rev. Proc. 2009-14 § 10.02.

[77] The APA Program tracks APA taxpayers by the dollar value of covered transactions, not asset size, so we cannot say precisely how many past or current APA taxpayers have assets of $10 million or less without a time-consuming review of hundreds of taxpayer balance sheets. We would not expect the number to be more than a few.

FinCEN continues to discuss electronic filing for the FBAR form as part of their Modernization Initiative. If the FBAR remains a Title 31 filing requirement, FinCEN could develop this capability as part of their Modernization Initiative, subject to the funding limitations and other priorities of that program.

Eliminate duplicative reporting of foreign financial accounts on income tax forms and FBAR forms.

The IRS and the Department of Treasury Financial Crimes Enforcement Network are currently working together to develop published guidance as well as revised FBAR form instructions. Eliminating all unnecessary duplicative reporting of foreign financial accounts is part of that effort.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate commends the IRS for the implementation of the Servicewide Approach to International Tax Administration. We are both appreciative of and pleased with the initiatives to understand the needs and preferences of U.S. taxpayers abroad, especially the survey of international customers the IRS conducted to determine the type of tax information they need and the best channels for delivering that information. The National Taxpayer Advocate looks forward to reviewing the results of this survey and is pleased to include a TAS representative in the W&I working group.[78]

The National Taxpayer Advocate is also very pleased that the IRS has agreed to develop a comprehensive strategy and outreach materials specifically targeting tax problems facing this taxpayer population. However, we reiterate that the IRS must identify the entire customer base before it can assess the needs of U.S. taxpayers living or conducting business abroad. The IRS suggests many of the estimated seven million American citizens residing abroad may not have filed U.S. tax returns because they may not have a filing requirement. We can agree that this assumption *may* be true, but we do not accept it as a valid reason for the IRS to not know or assess the numbers and needs of these citizens. It remains unacceptable from a customer service perspective to not know this customer base. Moreover, from a tax administration perspective, it is unacceptable to be unable to assess the filing compliance rate of these taxpayers.

We commend the IRS for working on creation of an outreach presentation for practitioners about the responsibilities small businesses have in dealing with businesses and independent contractors that are overseas. However, the National Taxpayer Advocate is

[78] This working group is a part of the W&I Seamless Taxpayer Experience Group. E-mail communiqué from W&I Director of Planning, Research, and Analysis (Dec. 1, 2009).

concerned that the IRS does not have a comprehensive strategy or a dedicated web page for U.S. small businesses conducting business abroad. By the IRS's own admission, "there are also a myriad of pages" dealing with specific industries and international activities. Small business taxpayers should not have to search hither and yon to obtain this information. SB/SE should take the lead in specifically targeting this taxpayer population comprising 96 percent of U.S. exporters. At the recent Senior Executive Team meeting at Wye River, Maryland, senior IRS leadership discussed the possibility of using closed-circuit television or Internet cameras to deliver assistance and case resolution from U.S. based personnel to taxpayers abroad. This technology would be relatively inexpensive and could be placed in U.S. embassies or consulates throughout the world. The National Taxpayer Advocate encourages the IRS to explore this approach and offers her office's assistance.

The National Taxpayer Advocate is pleased with the IRS's willingness to open case resolution rooms at tax attaché posts and tax venues abroad. TAS is offering its assistance to work with the IRS to resolve potential logistics issues associated with such venues.

However, the National Taxpayer Advocate is disappointed that the IRS disagrees with the suggestion to devote more tax attaché posts to taxpayer service, and especially with the IRS's refusal to maintain a post in Mexico City, largely for reasons of fiscal impracticality. Again, the business decision to move the Mexico City attaché to Florida, without taking into account the needs of American taxpayers in Mexico, suggests the decision was not only short-sighted but inconsistent with other IRS priorities for customer service. The IRS maintains TACs in many smaller population centers such as Aberdeen, South Dakota, and Presque Isle, Maine, but will not offer face-to-face service to the far more Americans residing or working in Mexico. It is unfair to dismiss taxpayer service needs on purported fiscal grounds, and it is unwise to ignore such a large taxpayer population whose tax compliance the IRS does not consider.

The National Taxpayer Advocate does not suggest closing the Plantation, Florida, post serving IRS enforcement goals in the Caribbean. We simply urge the IRS to reinstate in-person taxpayer service to U.S. taxpayers in Mexico. The National Taxpayer Advocate also believes the health and security concerns are largely overstated because the Department of State has not closed or reduced U.S. embassy services in Mexico. Moreover, the Criminal Investigation function has its own dedicated tax attaché in Mexico City. Since the IRS already has a presence in Mexico City, it should be able to assign additional personnel to help the more than one million U.S. taxpayers residing in this country.

The National Taxpayer Advocate believes individual U.S. taxpayers and small business abroad deserve the same level of confidence in the finality of a tax position on a return as large and midsize business taxpayers. Therefore, we suggest the IRS consider developing a program similar to the PFA program for this taxpayer population. The IRS should implement a pilot on a small scale to test the scope of raised issues, the possibility of cost

reduction, and the desirability of this program to small business taxpayers. TAS offers its assistance in this effort.

It is also very important to lower user fees for small business taxpayers for participation in the APA program. For example, the Canadian Revenue Agency charges a fixed, affordable fee of $5,000 (Canadian) to small business taxpayers for participation in the Canadian APA program.[79] The National Taxpayer Advocate applauds the IRS's willingness to lower this fee for the smallest taxpayers and urges the IRS to work with TAS on determining an affordable fee for this population.

Finally, the National Taxpayer Advocate acknowledges IRS efforts in working with the Department of Treasury Financial Crimes Enforcement Network to develop published guidance as well as revised FBAR form instructions. TAS is part of this effort. We look forward to creating easy-to-follow and taxpayer-friendly procedures for FBAR filing. The National Taxpayer Advocate will continue to monitor this effort to ensure that taxpayer rights are not violated and the processes and procedures are improved to address taxpayers' and practitioners' complaints.

Recommendations

The National Taxpayer Advocate recommends that the IRS take the following specific actions:

1. Develop a method to identify U.S. taxpayers located or conducting business abroad and assess their filing compliance rate.
2. Develop a comprehensive strategy and outreach materials, including a dedicated web page for small businesses, specifically targeting tax problems facing this taxpayer population based on the results of the survey of needs and preferences of U.S. taxpayers abroad.
3. Devote more tax attaché posts to taxpayer service, including reinstatement of in-person taxpayer service to U.S. taxpayers residing in Mexico.[80]
4. Open case resolution rooms at tax attaché posts and during tax venues abroad.
5. Implement a pilot of PFA for small businesses with reduced fees and reduce filing fees for the APA program for small businesses with assets of $10 million or less.

79 *See* Shiraj Keshvani, *Canada's APA Program*, presentation at the ABA Section of Taxation 2009 Joint Fall CLE Meeting, Chicago, IL (Sept. 25, 2009).

80 This goal may be achieved either by partially devoting existing tax attachés to taxpayer service or by assigning additional tax personnel to existing and planned CI attaché posts. CI has eight attachés in London, Ottawa, Frankfurt, Hong Kong, Barbados, Mexico City, Bogota, and Baghdad. In FY 2010, CI is hiring and adding seven attachés to existing posts and hiring three new attachés to the three new posts, going from eight current attachés to a total of 18 attachés. CI response to TAS research request (Aug. 7, 2009.

Introduction to Examination Issues: The IRS Examination Strategy Fails to Maximize Voluntary Compliance

Why discuss exam strategy and the tax gap as a most serious problem facing taxpayers?

The "tax gap" is the amount of tax not voluntarily and timely paid.[1] The National Taxpayer Advocate has been discussing tax gap and examination strategy related issues for years.[2] The tax gap is a problem for taxpayers because we all have to pay more to make up for those who do not pay their share. The tax gap also harms taxpayers by increasing the need for enforcement activity, conflict, and the danger of overreaching by the IRS.

Examinations are the IRS's primary tool to address underreported tax liabilities, which account for over 80 percent of the tax gap – $285 billion in 2001.[3] The IRS examines over 1.5 million returns each year.[4] Thus, examinations could have an enormous impact on the tax gap if the IRS's examination strategy gets it "right," which means selecting the right returns, minimizing taxpayer burden, getting to the right answer, and educating taxpayers. The right strategy should prompt taxpayers to comply with the tax rules voluntarily.[5]

Why focus on voluntary compliance?

According to IRS estimates, the indirect effect of an examination on voluntary compliance is between six and twelve times the direct effect, *i.e.*, the amount of the proposed adjustment.[6] The IRS goal is to raise the voluntary compliance rate by 2.3 points (from 83.7 percent in tax year 2001 to 86 percent by tax year 2009).[7] Based on the latest IRS estimates for FY 2001, this 2.3 point increase could have generated another $48.8 billion that year[8]

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1 We use the terms tax gap and gross tax gap interchangeably. According to the IRS's 2001 tax gap estimates – the most recent available – taxpayers timely and voluntarily paid $1.767 trillion (83.7 percent), and paid another $55 billion (2.6 percent) late or as a result of IRS enforcement, leaving $290 billion (13.7 percent) unpaid (the net tax gap). IRS, *Tax Gap Map for Year 2001* (Feb. 2007), http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf. These figures exclude unpaid tax on illegal activities.

2 *See, e.g.*, National Taxpayer Advocate 2003 Annual Report to Congress 20-26.

3 IRS, *Tax Gap Map for Year 2001* (Feb. 2007).

4 IRS Pub. 55B, Data Book, *Table 9a* (2009), http://www.irs.gov/pub/irs-soi/08db09aex.xls (reflecting 1,540,771 examinations in FY 2008).

5 As IRS policy acknowledges, "[t]he primary objective in selecting returns for examination is to promote the highest degree of voluntary compliance." Policy Statement 4-21(2), IRM 1.2.13.1.10 (approved June 1, 1974). Deterrence is not the only way for examinations to promote voluntary compliance. *See, e.g.*, National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 138 (discussing social norms and tax morale).

6 *See* Alan H. Plumley, *The Impact of the IRS on Voluntary Tax Compliance: Preliminary Empirical Results*, Nat. Tax Assoc. 95th Annual Conf. on Taxation 8 (Nov. 2002), http://www.irs.gov/pub/irs-soi/irsvtc.pdf (11.7 times the proposed 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, *Criminal Investigation Enforcement Activities and Taxpayer Noncompliance* 19 (May 2004), http://www.irs.gov/pub/irs-soi/04dubin.pdf (between six and seven times the proposed adjustment).

7 *See, e.g.*, IRS, *Reducing the Federal Tax Gap, A Report on Improving Voluntary Compliance* 10 (Aug. 2, 2007); IRS Strategic Plan, 2009-2013 (2009), http://www.irs.gov/pub/newsroom/long_term_measures.pdf.

8 By dividing the $345 billion dollar tax gap for 2001 by the 16.3 percent noncompliance rate, we see that a one percent improvement in that rate could bring in $21.2 billion. IRS, *Tax Gap Map for Year 2001* (Feb. 2007). If a one percent improvement brings in $21.2 billion, a 2.3 point improvement could bring in $48.8 billion (2.3 * $21.2 billion).

– significantly more than the $33.8 billion the IRS brought in directly through all enforcement activities in 2001.[9] The IRS would need to increase direct enforcement revenue by 144 percent ($48.8 billion / $33.8 billion) to match gains from a mere 2.3 point increase in voluntary compliance. Forty-eight billion dollars is also about six times the $7.9 billion the IRS brought in directly through examinations in FY 2001.[10] Because Congress is unlikely to fund the IRS to conduct six times as many examinations (or a similar amount of collection activity), the IRS's goal recognizes the only realistic way for examinations to narrow the tax gap significantly is to increase their indirect effect on voluntary compliance.

Moreover, the only practical way to address the growing tax gap attributable to the cash economy is to design an examination strategy that maximizes these indirect effects. Unreported business income, mostly from the cash economy (*i.e.,* income not subject to information reporting), is already responsible for the largest portion of the tax gap – more than $100 billion per year.[11] The IRS expects income generated in the cash economy to grow faster than income subject to third party information reporting.[12] Because it is difficult for the IRS to detect and correct this type of underreporting using traditional enforcement tools such as document matching, it is particularly important for the IRS to improve *voluntary* compliance among taxpayers who generate such income.[13]

The IRS is taking steps that may increase the impact of examinations on voluntary compliance.

In addition to the steps described in the examination-related "most serious problems" below, the IRS is trying to identify some of the causes of noncompliance by interviewing taxpayers after examining their returns.[14] It has also been working with TAS on a number of teams, which may improve the correspondence examination process, as follows.

- The Correspondence Examination Taxpayer Satisfaction Improvement Initiative is working to enhance communications with taxpayers under examination. The IRS is implementing one of the group's recommendations regarding telephone communications;

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9 IRS, *Fiscal Year 2008 Enforcement Results* (2009), http://www.irs.gov/pub/irs-news/2008_enforcement.pdf. Of the $33.8 billion in FY 2001 enforcement revenue, $24.3 billion was from collections, $7.9 billion was from examinations, and $1.6 billion was from document matching (*e.g.*, the Automated Underreporter Program (AUR)). *Id.*

10 IRS, *Fiscal Year 2008 Enforcement Results* (2009).

11 The unreported income tax gap associated with individual returns is comprised of: $109 billion in business income, $56 billion in non-business income, and another $39 billion in unreported self-employment tax, whereas overstated deductions or credits on individual returns only accounted for $15 billion and $17 billion, respectively. IRS, *Tax Gap Map for Year 2001* (Feb. 2007). While some fraction of the unreported self-employment tax is due to overstated deductions, unfiled returns, which underreport income, accounted for another $25 billion. *Id.*

12 *See, e.g.*, National Taxpayer Advocate 2007 Annual Report to Congress vol. 2 (*A Comprehensive Strategy for Addressing the Cash Economy*); Small Business/Self-Employed Division (SB/SE) Research, *Strategic Assessment FY 2009-FY 2010*, 22-25 (Feb. 2008).

13 Document matching accounted for only $4.7 billion – eight percent of the IRS's enforcement revenue – in FY 2008 (up from five percent in FY 2001). IRS, *Fiscal Year 2008 Enforcement Results* (2009).

14 *See* SB/SE Research, *Strategic Assessment FY 2009-FY 2010*, 22-23, 28 (Feb. 2008). S. Rep. No. 110-129 directed the IRS to "use an independent external survey firm to conduct interviews with [National Research Project] NRP taxpayers in order to identify the causes of taxpayer noncompliance." The term "NRP taxpayers" refers to taxpayers selected for audit in connection with IRS research.

- The Audit Reconsideration Team is working to determine why cases requiring audit reconsideration were not resolved through the initial audit process; and
- The Examination Communications Workstream of the Taxpayer Communication Taskgroup is working to improve written audit-related communications.

These are steps in the right direction, but the IRS can do more.

What else can the IRS do to maximize the impact of examinations on voluntary compliance?

The IRS has not fully implemented a number of the National Taxpayer Advocate's recommendations aimed at increasing examination productivity, quality, and the indirect effects of audits on voluntary compliance, as follows.

1. Research the effect of IRS examinations on voluntary compliance, including how the effect varies by taxpayer segment, type of issue, and type of examination, to enable the IRS to make better decisions about allocating examination resources;[15]
2. Require the examination function in each area to do at least some work with other IRS functions and local partners to address noncompliance by local cash economy businesses (*i.e.*, local compliance initiative projects or CIPs);[16]
3. Obtain more receipts-related data from state and local taxing authorities and match it against income reported on federal tax returns;[17]
4. Create an "income" database to help identify underreporting and improve audit efficiency;[18]
5. Develop a specialized audit program to detect the omission of gross receipts; and[19]
6. Revise Form 1040, Schedule C, *Profit or Loss from Business (Sole Proprietorship)* and business tax returns to promote voluntary compliance and increase the audit efficiency.[20]

The "most serious problems" that follow describe challenges the IRS continues to face in implementing these recommendations.

15 *See, e.g.*, National Taxpayer Advocate 2008 Annual Report to Congress 192; National Taxpayer Advocate 2004 Annual Report to Congress 225.

16 *See id.*

17 *See, e.g.*, National Taxpayer Advocate 2007 Annual Report to Congress 64; National Taxpayer Advocate 2005 Annual Report to Congress 55, 69; National Taxpayer Advocate 2004 Annual Report to Congress 225.

18 *See, e.g.*, National Taxpayer Advocate 2007 Annual Report to Congress 64 (recommendation 5).

19 *See id.*

20 *See, e.g.*, National Taxpayer Advocate 2007 Annual Report to Congress 64 (recommendation 7); National Taxpayer Advocate 2005 Annual Report to Congress 67-68.

MSP #8 The IRS Correspondence Examination Program Does Not Maximize Voluntary Compliance

RESPONSIBLE OFFICIALS

Chris Wagner, Commissioner, Small Business/Self-Employed Division
Richard E. Byrd Jr., Commissioner, Wage and Investment Division

DEFINITION OF PROBLEM

The IRS significantly expanded its use of correspondence examinations without first doing the research necessary to know if these audits actually increase or decrease voluntary compliance by the types of taxpayers now subject to them. As a result, the IRS may be using its resources ineffectively when it examines certain taxpayer groups or issues by correspondence.

ANALYSIS OF PROBLEM

Background

The IRS has increased its use of correspondence examinations.

Correspondence examinations accounted for 72 percent of all examinations in fiscal year (FY) 2008 (1,110,211 out of 1,540,771), up from 54 percent in FY 2000 (387,009 out of 715,915).[21] Therefore, the IRS must have concluded that correspondence examinations are better than other types of examinations in important respects.

The IRS is using correspondence examinations to increase "audit coverage."

Cost, not speed, is likely behind the IRS's increasing use of correspondence examinations. The IRS takes longer to complete a correspondence examination than an office examination. On average, in FY 2008 a correspondence examination took 213 days, while an office examination took 188 days.[22] However, IRS employees spent an average of only 1.6 hours in "direct time" on each correspondence examination in FY 2008, as compared to 8.5 hours on each office examination, and 46.4 hours on each field examination.[23] As a result, in FY

21 *Compare* IRS Pub. 55B, Data Book, Table 9a (2009), *with* IRS Pub. 55B, Data Book, *Table 10* (2001), *available at* http://www.irs.gov/pub/irs-soi/00db10ex.xls. We computed the correspondence examination totals for FY 2000 by adding the tax examiner and compliance center columns. Correspondence examinations accounted for almost 82 percent of the examinations of individuals in FY 2008. Treasury Inspector General for Tax Administration, Ref. No. 2009-30-082, *Trends in Compliance Activities Through Fiscal Year 2008* (June 10, 2009).

22 IRS response to TAS information request (May 15, 2009).

23 Automated Information Management System (AIMS), Compliance Data Warehouse (Sept. 15, 2009).

2008 the average labor cost associated with a correspondence examination was about $135, $540 for an office examination, and $2,834 for a field examination.[24]

The IRS's examination strategy is based on the conclusion that more audits (*i.e.*, audit coverage) generally lead to more compliance.[25] Obviously, not all audits are equally effective. However, if you assume any audit of any taxpayer using any audit process has the same positive effect on compliance, you would use the least costly audit technique (*i.e.*, correspondence examinations) for as many taxpayers as possible. Thus, some parts of the IRS may be operating under these simplistic assumptions.

Maintaining audit coverage will not necessarily maximize voluntary compliance.

In measuring the effectiveness of its examination function, the IRS focuses primarily on the number of examination closures for each taxpayer segment.[26] "Audit coverage" – the proportion of the returns that the IRS examines – increases as the IRS closes more examinations. It is thought to improve voluntary compliance by showing taxpayers that the IRS is likely to catch tax cheating. However, studies show that this kind of deterrence cannot fully explain the current level of voluntary compliance.[27] Moreover, an increase in audit coverage at the expense of quality may actually reduce voluntary compliance if taxpayers conclude that an examination will not detect tax cheating, or that the audit process is arbitrary or unfair.[28]

Correspondence examinations are unlikely to have the same positive effects on voluntary compliance as other examinations.

For some taxpayers or issues, correspondence examinations are more likely to reach the wrong result because of communication difficulties and the limited scope of these audits.[29] In 2004, TAS studied cases in which a correspondence examiner had denied the Earned Income Tax Credit (EITC) and the taxpayer subsequently requested audit reconsideration.[30]

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24 IRS response to TAS information request (May 20, 2009). These individual examination figures were computed by multiplying the average unit costs per staff year by the number of staff years, and dividing the product by the total number of individual examination closures.

25 Office of Management and Budget, *Detailed Information on the Internal Revenue Service Examinations Assessment* (2005) (citing "a study by Professor Jeffrey Dubin which suggests that higher audit rates lead to higher compliance.").

26 *See, e.g.*, Small Business/Self-Employed Division (SB/SE), *Business Performance Review* (May 11, 2009) (reflecting the number or percentage of cases or planned actions completed on every chart in the Examination and Campus Compliance Services sections, but omitting any quality or voluntary compliance metrics, except for the customer satisfaction survey); SB/SE's Examination Program Letter for FY 2009 (Oct. 27, 2008) ("[O]ur [examination] workplan balances [audit] coverage across broad categories by return types"). Government Accountability Office, GAO-05-753, *Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap* 22 (July 2005) ("Although IRS has not focused on quantitative, results-oriented goals for improving voluntary compliance, IRS has established many output-related goals and measures that track activity level, such as the number of taxpayers contacted, collection cases closed, or returns examined. In contrast, IRS has fewer outcome-related goals and measures that track results, such as refund timeliness or examination quality.").

27 *See, e.g.*, Richard Lavoie, *Cultivating a Compliance Culture: An Alternative Approach for Addressing the Tax Gap*, U. of Akron Legal Studies Research Paper No. 08-05, 5-7 (Sept. 1, 2008); National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 138 (Marjorie E. Kornhauser, *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*).

28 *See, e.g.*, Alan H. Plumley, Pub. 1916, *The Determinants of Individual Income Tax Compliance: Estimating the Impacts of Tax Policy, Enforcement, and IRS Responsiveness* 18 (Oct. 1996) (discussing this possibility).

29 *See, e.g.*, National Taxpayer Advocate 2006 Annual Report to Congress 289-310.

30 *See* National Taxpayer Advocate 2004 Annual Report to Congress vol. 2 (*Earned Income Tax Credit (EITC) Audit Reconsideration Study*).

Communication and documentation difficulties in the original examination prompted 42 percent and 45 percent, respectively, of the requests for audit reconsideration.[31]

In nearly 17 percent of the cases in which taxpayers requested reconsideration because of communication difficulties, taxpayers indicated they were not even aware of the original examination. Forty-three percent ultimately received the EITC, and the amount received was, on average, 96 percent of what the taxpayer claimed on the original return.[32] In essence, the likelihood that the IRS had obtained the right result the first time was not much better than a coin toss would produce.

The IRS is more likely to overcome communication difficulties and reach the correct result if the examiner and the taxpayer can communicate freely, either in person or by phone. The IRS simply cannot examine some issues effectively by correspondence, especially those requiring taxpayers to locate, copy, mail, and explain a large amount of documentation.[33] For example, associations representing actors, performers, entertainers, and journalists recently expressed concern that correspondence examiners improperly deny deductions for their members and unnecessarily burden them with requests to copy and send large amounts of documentation through the mail.[34] As another example, one study found that nearly three quarters of the taxpayers subject to an EITC correspondence examination contacted the IRS in person or by phone, and 60 percent of these taxpayers needed clarification about what documents they needed to produce.[35]

Because of communication difficulties and the fact that correspondence examinations generally address only a few narrow issues, the process is also less likely to detect significant noncompliance than other types of examinations.[36] Examinations that result in inaccurate adjustments against compliant taxpayers or do not detect significant noncompliance are likely to reduce rather than increase voluntary compliance, notwithstanding any positive effect they have on audit coverage.

Taking steps to minimize communication difficulties could improve the correspondence examination process.

After TAS identified problems with the use of correspondence examinations for employee business expense deductions, a multifunctional Correspondence Examination Taxpayer Satisfaction Improvement Initiative proposed a pilot program called "Optimize the Documentation Request & Review Process." This pilot would develop tools and training

31 *See* National Taxpayer Advocate 2004 Annual Report to Congress vol. 2, 20-21 (*Earned Income Tax Credit (EITC) Audit Reconsideration Study*).

32 *Id.* at 9.

33 For example, examinations involving cash economy businesses, Alternative Minimum Tax, alimony, or nonfilers may not be appropriate to conduct by correspondence. *See* National Taxpayer Advocate 2006 Annual Report to Congress 306-10; National Taxpayer Advocate 2005 Annual Report to Congress 58-59.

34 Letter from Mark Zimmerman, President, Actors' Equity Association to the National Taxpayer Advocate (June 18, 2009) (enclosing letters from four associations).

35 National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 94 (*IRS Earned Income Credit Audits — A Challenge to Taxpayers*). About 70 percent of these EITC taxpayers indicated they would have preferred the IRS to conduct the examination by means other than correspondence. *Id.*

36 SB/SE, *Criteria for Referral to Campus Correspondence Exam* (Feb. 14, 2005); Form 13649, *Multi-Case Inventory Referral* (Dec. 2004).

addressing (1) the types of expenses allowed for a wide variety of occupations, (2) alternative types of acceptable documentation, and (3) the use of sampling techniques in lieu of documentation.

A related joint Phone Optimization Project (POP) team is considering a pilot that would use training and improved call routing to increase the likelihood that a taxpayer would reach an IRS employee (rather than voicemail) and that the employee would be able to access all of the information pertinent to resolving the taxpayer's case. The POP team also considered the use of online tools to assist employees in determining alternative forms of employee business expense documentation that would be acceptable. The changes contemplated by the Optimize the Documentation Request & Review Process and POP pilots could help to address the actual and perceived unfairness of using correspondence examinations to address employee business expense deductions.

Quantifying the effect of examinations on voluntary compliance would help the IRS reach its goals.

As noted above, the IRS's goal is to increase the voluntary compliance rate from 83.7 percent in 2001 to 86 percent in 2009.[37] Another IRS objective is to "[u]se data and research across the organization to make informed decisions and allocate resources."[38] Different types of examinations have different direct and indirect effects on compliance. Studying these effects could help the IRS quantify the true effect of various examination strategies, set priorities, and allocate examination resources more efficiently; and would be consistent with the IRS's plan to make decisions based on data and research.

What the IRS is doing

In response to recommendations in the National Taxpayer Advocate's 2008 Annual Report, the IRS plans to compare correspondence examinations with face-to-face examinations of similar issues (including EITC and employee business expenses) through the entire examination cycle, including any audit reconsideration that is required.[39] This is a significant step in the right direction. While the IRS is not presently implementing the Correspondence Examination Taxpayer Satisfaction Improvement Initiative's recommendation to improve the examination of employee business expenses through the Optimize the Documentation Request & Review Process pilot, we understand that it is tentatively planning to implement the POP pilot to improve telephonic communications. However, it is still not researching the effect of examinations on voluntary compliance.

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37 *See, e.g.*, IRS, *Reducing the Federal Tax Gap, A Report on Improving Voluntary Compliance* 10 (Aug. 2, 2007); Office of Management and Budget, *Detailed Information on the Internal Revenue Service Examinations Assessment* (2005).

38 IRS Pub. 3744, *IRS Strategic Plan 2009-2013*, 30 (Apr. 2009).

39 National Taxpayer Advocate 2008 Annual Report to Congress 240-42. As of this writing, however, we understand the IRS had not begun any such research. SB/SE Research is also planning to explore the demographics of taxpayers who require audit reconsideration and why they request it. SB/SE response to TAS information request (June 17, 2009).

In its response to the National Taxpayer Advocate's 2007 Annual Report, the IRS stated, "[t]he 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."[40] While SB/SE and W&I still have no plans to initiate this specific research, IRS researchers are planning long-term studies to quantify the effect of service (while controlling for the effect of examinations on voluntary compliance) to guide resource allocation decisions.[41] In addition, the IRS plans to study the effect of certain "enforcement actions" by comparing compliance by sole proprietors in 1988 with compliance in 2001.[42] The results of these studies should help the IRS to make more informed resource allocation decisions. While they are steps in the right direction, the IRS will need significantly more research if it is serious about its objective to base resource allocation decisions on data and research.

CONCLUSION

Research into the effect of various examination strategies on voluntary compliance will be difficult but not impossible. In the past, IRS researchers have been able to measure the effect of various IRS activities on compliance, and the IRS plans to do more research in this area.[43]

In conclusion, the National Taxpayer Advocate offers the following preliminary recommendations:

1. Expand the scope of the IRS's research agenda to answer questions such as:
   - To maximize voluntary compliance, should the IRS use more correspondence examinations, office examinations, or face-to-face examinations in cash economy industries? To what extent does the answer depend on the industry?
   - To achieve the greatest impact on voluntary compliance, should the IRS cluster audits of local businesses either geographically or within industries to generate maximum publicity and possibly change local or industry norms?[44]

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40 National Taxpayer Advocate 2007 Annual Report to Congress 52 (IRS comments).

41 IRS response to TAS information request (May 15, 2009) ("[c]urrently, our OD functions do not and are not planning, any research projects which would quantify the effect of examination-related activities on voluntary compliance."); IRS response to TAS information request (June 17, 2009) (describing long-term studies).

42 *See* SB/SE Research, *Strategic Assessment FY 2009-FY 2010*, 28 (Feb. 2008) (stating that one project "will explore the effect that enforcement actions have on compliance. It will study changes in compliance among sole proprietors over time by comparing the 2001 NRP results to the 1988 Taxpayer Compliance Measurement Program (TCMP) results."). It is unclear how the IRS will control for other factors that could affect compliance over such a long period.

43 *See, e.g.*, Alan H. Plumley and C. Eugene Steuerle, *The Crisis in Tax Administration, Ultimate Objectives for the IRS: Balancing Revenue and Service*, 311, 336 (Henry J. Aaron and Joel Slemrod, eds., Brookings Institution Press 2004) (noting "[O]bviously, since these compliance impacts are not observed in isolation, quantifying them is extremely difficult – but it is not impossible. A couple of studies have already made preliminary estimates for individual income tax.").

44 The IRS Examination Specialization (ES) Program, formerly called the Market Segment Specialization Program (MSSP) and Audit Technique Guides (ATGs) allow examiners to gain industry-specific expertise. See Internal Revenue Manual (IRM) 4.28.1 (Mar. 4, 2008). The ES Program may use compliance initiative projects (described below) to identify workload. IRM 4.28.1.1.4 (Mar. 4, 2008). However, ES Program has become more of a national program than a local one. See IRM 4.28.1.1.2 (Mar. 4, 2008).

- Do audits have an even greater indirect effect on compliance when coupled with outreach and education targeting unaudited members of the same community?[45]

2. Commence the planned research (described above) to compare correspondence examinations with face-to-face examinations of similar issues, including EITC and employee business expenses. This research should compare accuracy, case disposition, appeals, litigation, audit reconsideration, and similar measures for three types of examinations – office examinations, correspondence examinations with extensive telephonic communications, and normal correspondence examinations – for different taxpayer segments (*e.g.*, those with and without representation, etc.); and
3. Work with TAS to expand the Phone Optimization Project pilot to address the documentation issues identified by the Correspondence Examination Taxpayer Satisfaction Improvement Initiative.

IRS COMMENTS

The IRS continually strives to improve our programs and considers the Correspondence Examination Program an integral part of the IRS overall strategy for combating non-compliance and addressing the tax gap. As supported through ongoing discussions we have with practitioners, we believe the Correspondence Examination Program contributes to voluntary compliance. We actively engage the tax practitioner community through tax forums, practitioner telephone calls, and practitioner focus groups. A balanced approach is applied to the program in terms of issues, scope, methodology, satisfaction, and quality. The program includes key measures for quality,[46] along with customer and employee satisfaction that are monitored monthly.

The Correspondence Examination Program works with Research to develop business models that are used to determine appropriate compliance treatment streams. The models are refined annually based on prior year examination outcomes. A treatment stream may be outreach, an educational soft notice, or a pre or post-refund examination contact. These models ensure that the most complex issues are appropriately addressed by Field Examination.

As noted in the National Taxpayer Advocate's report, the IRS has increased its use of correspondence examinations. This is part of the overall strategy to close the tax gap by identifying issues which can be addressed through correspondence that may otherwise remain untouched by other compliance streams. It is worth noting that the major differences in the compliance treatment streams cited in the National Taxpayer Advocate's report are primarily driven by complexity of the issue. While cost can be a factor in considering the correct treatment stream, complexity of the issue and the likelihood of resolving that

45 ES Program guidance suggests outreach is a component of that program. IRM 4.28.1.2 (Mar. 4, 2008). IRS guidance also states that "[r]esearch will be performed that will develop workload selection systems and compliance measures for identified segments." IRM 4.28.1.1.2 (Mar. 4, 2008).

46 Correspondence Examination Quality Measures include: Customer Accuracy, Professionalism and Timeliness for Exam Paper and Phones.

issue through correspondence are the primary factors in the decision to put a case in the Correspondence Examination Program.

In her report, the National Taxpayer Advocate makes three preliminary recommendations to improve the impact of the Correspondence Examination Program to voluntary compliance. We are taking or have taken the following actions with respect to these recommendations:

The National Taxpayer Advocate recommends that the IRS expand the scope of its research agenda. The IRS does not see the benefit of expanding its research with respect to the Correspondence Examination Program at this time. For example, our experience has determined that cash economy industry issues are not conducive to correspondence examinations. Correspondence examinations are not effective at addressing unreported cash income and are instead focused on credit and deduction issues. Similarly, discussions with Research regarding trying to gauge the local indirect impact of examinations have indicated that, considering the nature of the current spread of information (*i.e.*, the Internet), clustering examinations geographically would likely be ineffective. However, we do believe examinations are likely to have a greater indirect effect on compliance when coupled with outreach and education targeting non-examined members of the community. The IRS has actively engaged the practitioner community, and tax professionals, including those representing low income taxpayers, in its compliance efforts. These partnerships have helped in resolving issues while providing feedback affecting all customer segments.

As part of our planned research, the IRS submitted a research request in September 2009[47] to compare the results of correspondence audits and face-to-face audits with similar issues. SB/SE will work with TAS staff and Research to focus on agreements, adjustments, satisfaction (employee and taxpayer), educational opportunities and cycle time. The research request will provide a keen insight into the differences between office examination and correspondence examinations which include telephonic communications.

The IRS is working with TAS to expand the Phone Optimization Project, to address the documentation issues identified by the Correspondence Examination Taxpayer Satisfaction Improvement Initiative. A Project Code Search Tool has been developed to help IRS employees when evaluating case documentation provided by the taxpayer.

[47] It should be noted that there are limited results on EITC in the field as this is not an issue normally covered by face-to-face examinations. This SB/SE research request has not been numbered.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased the IRS is working with TAS to address examination documentation issues. If properly designed and executed, its tentative plans to compare the results of correspondence and field audits of similar issues could also be helpful.

The National Taxpayer Advocate disagrees, however, with the conclusion presented in the IRS comments that its models ensure the most complex issues are being addressed through field examinations. The results of the TAS EITC study (described above) and documentation problems acknowledged by the IRS show that its models do not ensure that complex issues are always addressed by Field Examination. EITC and employee business expense deduction issues can be very complex. For example, the section of the Internal Revenue Code that contains the EITC goes on for eight pages (including 168 paragraphs or 2,647 words);[48] the IRS publication that explains it is 56 pages;[49] and those claiming the EITC may need to fill out one schedule and two worksheets.[50] Further, one of the IRS's stated goals for this year is to "[E]xpand workload selection in Correspondence Examination to *complex* Business Master File (BMF) and Individual Master File (IMF) workloads."[51]

When the IRS addresses complex issues like the EITC through correspondence examinations – as it is now planning to do – it is more likely to reach an incorrect result. The TAS EITC study found more than 95 percent of taxpayers faced EITC audits without representation, even though represented taxpayers were more likely to obtain a more favorable outcome.[52] This is perhaps because representation helps them overcome communication difficulties. Moreover, taxpayers wanted the personal contact necessary to overcome these difficulties – over 70 percent would have preferred to have an audit by means other than correspondence.[53]

In addition to these problems, the IRS does not know whether or how its growing use of correspondence examinations affect the goal it seeks to achieve – increasing voluntary compliance. According to its comments, the IRS does not see the benefit of expanding its research with respect to the Correspondence Examination program. Instead of relying on data and research to make resource allocation decisions, as set forth in the IRS Strategic Plan, these comments suggest the IRS is making important examination resource allocation decisions based on untested assumptions and speculation.[54]

48 We computed this figure using Microsoft Word's Word Count function after copying the current version of IRC § 32 from Westlaw into Word.

49 IRS, Pub. 596, *Earned Income Credit* (2008).

50 The schedule is Form 1040, Schedule EIC. The EITC worksheets include Worksheet 1 and Worksheet B. *See* IRS, Pub. 596, *Earned Income Credit* (2008).

51 SB/SE, Campus Compliance Services Program Letter for FY 2010 (Sept. 28, 2009) (emphasis added).

52 National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 94 (*IRS Earned Income Credit Audits — A Challenge to Taxpayers*).

53 *Id.*

54 IRS Pub. 3744, *IRS Strategic Plan 2009-2013*, 30 (Apr. 2009) (promising to "[u]se data and research across the organization to make informed decisions and allocate resources.").

For example, the IRS comments suggest correspondence examinations are good for addressing credit and deduction issues in cash economy industries, but not for addressing unreported cash income. We agree they are not good for addressing unreported income. If the IRS examines a taxpayer in a cash economy industry and focuses only on credit and deduction issues, it could actually reduce voluntary compliance if the examination does not detect the unreported income, notwithstanding any positive effect the examination has on audit coverage.[55] If so, the IRS should not be auditing cash businesses by correspondence, even if it is only examining credit or deduction issues. Moreover, if research finds the IRS is wasting resources on examinations that reduce compliance, it could reallocate those examination resources to more productive activities.

Next, the IRS comments conclude, based on only "discussions with Research" that clustering examinations in a local geographic area would not improve their impact on voluntary compliance "considering the nature of the current spread of information (*i.e.*, the Internet)." More likely, the answer depends on the industry and the geographic region in question. Only actual research can answer this important question. If the IRS could identify industries where clustering would be helpful, it could allocate its examination resources more effectively. [56]

Finally, the IRS comments conclude that examinations are likely to have a greater indirect effect on compliance when coupled with outreach and education targeting non-examined members of the community. If so, the IRS needs at least a ballpark idea of how much more effective examinations are at improving voluntary compliance when coupled with outreach and education targeting the same local community. It also needs to know which issues it makes sense to address with a combination of examinations and outreach. Only after it has this information can the IRS make informed decisions about how to allocate resources.

[55] Such examinations may also squander the IRS's one and only chance to correct the return by including the unreported income. *See* Rev. Proc. 2005-32, 2005-1 C.B. 1206 (generally permitting only one examination of a taxpayer's return for a given year).

[56] The IRS's reorganization to focus on specific taxpayer groups and the IRS's Examination Specialization (ES) Program are both based on the idea that different taxpayer groups require different approaches. *See* IRM 4.28.1 (Mar. 4, 2008).

Recommendations

The National Taxpayer Advocate offers the following recommendations:

1. Expand the scope of the IRS's research agenda to provide more actionable information by answering questions such as:
   - How does an examination that addresses deduction or credit issues, but overlooks unreported income, affect voluntary compliance? Can we quantify the effect? Does it vary by industry?
   - Do audits have a larger impact on voluntary compliance when the IRS clusters them geographically or within industries? Can we quantify the magnitude of any such effect by geographic region or industry?
   - For which issues is an examination and outreach combination most effective in improving voluntary compliance? For each examination issue or taxpayer segment, can we quantify the extent to which the addition of outreach or education magnifies the impact of the examination on voluntary compliance?
2. Commence the planned research (described above) to compare correspondence examinations with face-to-face examinations of similar issues, including EITC and employee business expenses. This research should compare accuracy, case disposition, appeals, litigation, audit reconsideration, and similar measures for three types of examinations – office examinations, correspondence examinations with extensive telephonic communications, and normal correspondence examinations – for different taxpayer segments (*e.g.*, those with and without representation, etc.);
3. Do not expand the use of correspondence examinations to more complex cash economy businesses before completing research to know the effect of such examinations on voluntary compliance; and
4. Continue working with TAS to expand the Phone Optimization Project pilot to address the documentation issues identified by the Correspondence Examination Taxpayer Satisfaction Improvement Initiative.

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

RESPONSIBLE OFFICIALS

Chris Wagner, Commissioner, Small Business/Self-Employed Division
Richard E. Byrd Jr., Commissioner, Wage and Investment Division

DEFINITION OF PROBLEM

Local compliance initiative projects (CIPs), especially those involving cooperation by more than one IRS function, can have a greater effect on voluntary compliance than seemingly random examinations. However, the IRS does little to encourage local areas to develop them and has no national measures that can reliably distinguish good CIPs from bad ones. As a result, the IRS is missing opportunities to maximize voluntary compliance at the local level.

ANALYSIS OF PROBLEM

Background

Local compliance initiative projects are likely to have a greater effect on voluntary compliance by cash economy businesses than seemingly random examinations.

While examinations that target any given group of businesses may make those businesses feel unfairly singled out, local examination strategies, which rely on local data sources or utilize local partners, are likely to uncover unreported business income in a given community more effectively than national return selection techniques. Research suggests that because small businesses communicate with each other, local examination strategies can have a greater indirect effect on voluntary compliance than seemingly random examinations.[1] In other words, singling out local cash business segments where noncompliance is the norm can be effective, in part, because those segments do feel singled out.

The IRS could magnify such indirect effects by using compliance initiative projects. A CIP could enable IRS employees in a given geographic area to assemble multifunctional teams (including Examination, Collection, TAS, Stakeholder Partnerships, Education and Communication (SPEC), and Stakeholder Liaison employees) to collaborate with local stake-

[1] *See, e.g.,* Jon S. Davis, *et al.*, *Social Behaviors, Enforcement, and Tax Compliance Dynamics*, 78 Acct. Rev. 39 (2003). Although returns selected by IRS computer algorithms are not randomly selected, they may appear random from a taxpayer's perspective.

holders to identify and address the root causes of local compliance problems.[2] For example, the SPEC and Stakeholder Liaison functions could help educate taxpayers so the IRS does not need to conduct as many examinations. The Collection function could help to ensure the IRS promptly collects any examination assessments. TAS could voice the taxpayer's perspective in planning the CIP and help taxpayers and the IRS resolve complex problems that may result. This multifunctional approach to CIPs could maximize the indirect effect of examinations on voluntary compliance.

IRS procedures may discourage local CIPs.

The IRS's focus on traditional examination metrics may discourage it from using CIPs. The IRS is supposed to terminate a CIP if returns selected for audit do not produce better examination results than those selected by computer.[3] Traditional examination metrics such as dollars per hour, however, are not well suited for evaluating the overall success of examinations in improving voluntary compliance at the local level.[4] For example, some CIPs that generate small assessments may have large effects on voluntary compliance.[5] A CIP is also a test that may generate better results as the IRS refines it over time. In addition, if alternative treatments associated with a CIP, such as education and outreach, begin to improve voluntary compliance, traditional examination metrics might suggest that effective CIPs – those with a large impact on voluntary compliance – should be discontinued. Because the IRS naturally focuses on measures, its efforts will not be as efficient or effective if it does not at least try to measure the impact of its activities (including CIPs) on the goal it wishes to achieve – increasing voluntary compliance.[6]

Without measures to illustrate the impact of CIPs, the IRS is unlikely to allocate sufficient resources to them. Pursuant to the national examination plan, each IRS area is required to examine a specific number of returns of various types of taxpayers each year.[7] The plan does not specifically allocate resources to pursue CIPs, which are "discretionary" work.[8]

If IRS areas are already working at full capacity, area managers are less likely to encourage employees to seek out additional work that is discretionary by proposing a CIP, especially

2 The IRS research function could also assist with design or analysis of certain local CIPs. For additional information, see National Taxpayer Advocate 2008 Annual Report to Congress 176-92.

3 IRM 4.17.4.7 (Feb. 1, 2004).

4 Pursuant to the Abusive Tax Avoidance Transaction (ATAT) Collection Program, the Collection function collects assessments immediately after the Examination function completes its work. Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2009-30-092, *Collection Actions on Abusive Tax Avoidance Transaction Cases Are Generally Effective, but Measures to Evaluate Performance Results Are Needed* (June 19, 2009). TIGTA observed that the IRS has no way to measure the overall success of the ATAT Collection Program. *Id.* The IRS faces the same problem in connection with multifunctional CIPs.

5 Another challenge is that the IRS compares local CIP results to aggregate Area-wide examination results, which may cover a multi-state region. See National Taxpayer Advocate 2008 Annual Report to Congress 176, 182.

6 The National Taxpayer Advocate recommended the IRS "develop better measures of the impact of CIPs (including alternative treatments) and traditional examinations on voluntary compliance." National Taxpayer Advocate 2008 Annual Report to Congress 176, 192.

7 *See generally* IRM 4.1.1.1 (Oct. 24, 2006).

8 IRS response to TAS information request (May 15, 2009) (FY 2009 exam plan).

if these examinations do not fit into the national examination plan.[9] These factors likely reduce the resources allocated to local CIPs.

What the IRS is doing

The IRS included language in its fiscal year (FY) 2009 Examination Program Letter encouraging the local areas to use CIPs, and plans to train Area coordinators to prepare them.[10] In addition, the Areas have been working with the Governmental Liaison function to obtain and use state and local data, such as license- and permit-type data, to develop local CIPs.[11] The IRS has also agreed to begin tracking the number of CIPs that identify alternative treatments, such as outreach, education, or a soft notice (*i.e.*, a letter designed to prompt taxpayers to correct discrepancies voluntarily).[12] Out of a sample of nine local CIPs approved in 2008 or 2009, six identified alternative treatments such as outreach or a letter.[13]

While the IRS's official response to the National Taxpayer Advocate's 2008 report suggested it had given up on designing better measures of the impact of its CIP-related activities on voluntary compliance,[14] the IRS recently met with the research function to discuss the feasibility of doing so.[15] However, the IRS's official response also did not agree with our recommendation that the IRS require each area to devote some resources to identifying and addressing local problems using local CIPs (*e.g.*, by working with local partners and local sources of data).[16]

CONCLUSION

In conclusion, the National Taxpayer Advocate offers the following preliminary recommendations:

1. Continue work to develop better measures for the CIP program; and
2. Require each area examination function to do at least some CIP work with other IRS functions and local partners, using local data sources to address noncompliance by local cash economy businesses.

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9 The areas generally responded to the proposed FY 2008 IRS examination plan by explaining why existing resources were insufficient to meet proposed targets. IRS response to TAS information request (Apr. 28, 2008) (area responses to FY 2008 exam plan).

10 SB/SE, *Examination Program Letter for FY 2009* (Oct. 27, 2008); National Taxpayer Advocate 2008 Annual Report to Congress 189 (IRS comments).

11 IRS response to TAS information request (May 15, 2009).

12 IRS response to National Taxpayer Advocate recommendations, Joint Audit Management Enterprise System (JAMES) A6, TAS-07-ARC-001MSP (Nov. 24, 2008).

13 IRS response to TAS information request (May 15, 2009) (TAS review of nine CIPs).

14 National Taxpayer Advocate 2008 Annual Report to Congress 189 (noting in the IRS comments that "[A]lthough a further analysis of the deterrent affects on noncompliance of alternative treatments may be helpful, we have not found a meaningful way to measure this effect."). In past years the IRS did, in fact, develop and use various measures (*e.g.*, increases in the number of filers, decreases in the penalty rate, etc.) to evaluate the impact of local projects on voluntary compliance. *Id.* at 191 n.72.

15 IRS response to TAS information request (June 17, 2009). The IRS later clarified that it was not working with the research function to develop better measures. IRS response to TAS information request (Nov. 11, 2009).

16 National Taxpayer Advocate 2008 Annual Report to Congress 189 (IRS comments).

IRS COMMENTS

The IRS selects a large percentage of its examinations using the Discriminant Index Function (DIF) computer scoring system. These scores are developed from information obtained and periodically updated from our National Research Program examinations. Returns selected under this system have a higher probability of tax errors than a random selection system.

The IRS agrees with the National Taxpayer Advocate's report, however, that local examination strategies have an indirect effect on voluntary compliance and we encourage the development of compliance initiative projects. Though the National Examination Plan does not specifically allocate resources to pursue CIPs, which are "discretionary" work, development of local compliance initiatives is encouraged through the Examination Program Letter. For FY 2010, the Examination Program Letter specifically lists CIPs as an Examination priority.[17] The letter is reviewed and discussed by Examination group managers with their examiners during group meetings. Additionally, local Area CIP coordinators encourage the development of CIPs.

In order to evaluate the effectiveness of CIP results, the IRS uses traditional examination measures in monitoring each project such as dollars per hour, average dollars per return, no change rates, and related return pick up percentage. The IRS believes that these are reliable measures, and that they distinguish productive CIPs from unproductive ones. Unproductive CIP's are terminated to reduce taxpayer burden and reserve limited compliance resources. However, in response to a recommendation in the National Taxpayer Advocate's 2008 report, we have begun discussions with SB/SE Research on ways to best analyze CIP results.

In her report, the National Taxpayer Advocate suggests that a CIP would enable IRS employees in a given geographic area to assemble multifunctional teams (including Examination, Collection, TAS, Stakeholder Partnerships, Education and Communication (SPEC), and Stakeholder Liaison employees) to collaborate with local stakeholders to identify and address the root causes of local compliance problems. Although we currently do not have any local cross-functional CIPs, we agree that there may be some benefit to local cross-functional CIPs which could include Examination, Collection, TAS, SPEC, and Stakeholder Liaison.

The National Taxpayer Advocate's report states that if IRS Areas are already working at full capacity, Area managers are less likely to encourage employees to seek out additional work that is discretionary by proposing a CIP, especially if these examinations do not fit into the National Examination Plan. We have not found this to be the case. We encourage Area examiners to identify trends of non-compliance when conducting exams and to refer issues of non-compliance to the local Area CIP coordinator for possible initiation of a local CIP.

[17] W&I does not use CIPs for workload identification and selection per IRM 4.17.1.3, since projects are included in the W&I work plan.

This is reflected in the fact that during FY 2008 and FY 2009, 55 and 72 CIPs respectively were initiated.

In her report, the National Taxpayer Advocate makes two preliminary recommendations to improve voluntary compliance at the local level. We are taking or have taken the following actions with respect to these issues:

The IRS believes that the current examination measures such as dollars per hour, average dollars per return, no change rates, and related return pick-up percentage are reliable measures that allow for productive use of compliance resources. The IRS does not believe that additional measures are necessary.

The IRS does not believe there would be added benefit to mandating that each Examination Area work cross-functional CIPs. This is supported by the fact that, without an arbitrary mandate, every Area initiated local CIPs in FY 2009 and, as indicated above, the number of CIPs initiated in FY 2009 increased over those in FY 2008. This indicates the ability and desire of the Areas to work local CIPs independent of any mandate.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that SB/SE's FY 2010 Examination Program Letter specifically lists CIPs as an Examination priority. However, the letter does not encourage Examination employees to work with other functions and local partners, using local data sources. Nor does it specifically encourage the use of CIPs to address noncompliance by cash economy businesses, which represents the largest portion of the tax gap.[18]

More importantly, not every CIP examination is equally effective at achieving the IRS goal of increasing voluntary compliance. In some cases, current examination measures may be helpful. In other cases, such as audits of compliance with information reporting requirements, these measures are largely irrelevant. They also may be an ineffective way to measure the success of multi-functional CIPs that seek to leverage voluntary compliance by combining examinations with other treatments. Thus, the IRS does need additional measures, or at the very least, better ways to analyze CIP results. The IRS statement that better measures are unnecessary is akin to taking the position that our goal is to win the World Series, but we do not believe it is necessary to keep score.

Because it is particularly difficult for the IRS to detect and deter underreporting in the cash economy, it is important for the IRS to gain knowledge about how to increase voluntary

18 IRS, *Tax Gap Map for Year 2001* (Feb. 2007).

compliance in local cash economy industries. However, the IRS comments discount the need to require each area examination function to do at least some CIP work with other functions and local partners, using local data sources to address noncompliance by local cash economy businesses. As support for its conclusion, the IRS states that every Area initiated CIPs in FY 2009. However, out of the 72 CIPs initiated in FY 2009, only one involved another IRS function and only seven utilized state or local data, and we could not determine how many of these focused on cash economy businesses.[19] Thus, it may be reasonable to mandate at least some minimum number of CIPs that involve other IRS functions, local partners, use local sources of data, and focus on local cash economy businesses. TAS stands ready to help the IRS develop cross-functional initiatives.

Recommendations

The National Taxpayer Advocate offers the following recommendations:

1. Work with the research function to develop better measures for the CIP program or at least better ways to analyze and evaluate CIP results; and
2. Require each area examination function to do at least some CIP work with other IRS functions and local partners, using local data sources to address noncompliance by local cash economy businesses.

[19] IRS response to TAS information request (Nov. 16, 2009).

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

RESPONSIBLE OFFICIALS

Chris Wagner, Commissioner, Small Business/Self-Employed Division
Richard E. Byrd Jr., Commissioner, Wage and Investment Division

DEFINITION OF PROBLEM

The IRS faces a number of challenges in using state and local data to maximize voluntary compliance. Most importantly, the IRS has no measures to show if one examination is better at promoting voluntary compliance than another. As a result, it may be difficult for the IRS to justify examining returns selected based on state and local data instead of those selected using other means.

ANALYSIS OF PROBLEM

Background

In 2004, the National Taxpayer Advocate recommended the IRS obtain more receipts-related information from state and local government agencies, including income and sales tax reporting as well as other types of local filings.[1] By comparing this data to income reported on returns, the IRS could improve its ability to identify unreported income and nonfilers, and improve audit efficiency.[2] The IRS's use of information other than third-party information reporting to detect unreported income is likely to prompt taxpayers operating in the cash economy to report more of their income even if it is not subject to information reporting – increasing voluntary compliance among taxpayers responsible for the largest component of the tax gap.[3]

What the IRS is doing

The following programs allow the IRS to obtain and use state or local data:[4]

- *The State Reverse File Matching Initiative (SRFMI).* Pursuant to a four-phase SRFMI pilot project, the IRS receives state tax data reflecting individual income, corporate

1 National Taxpayer Advocate 2004 Annual Report to Congress 225.

2 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. Small Business/Self-Employed Division (SB/SE) Research, Project No. BKN0048, *Matching State of Iowa Sales Tax Data Against Gross Receipts Reported to IRS* (Feb. 2007). The figures cited include taxpayers who filed Form 1040, Schedule C, *Profit or Loss From Business (Sole Proprietorship)* Form 1065, *U.S. Return of Partnership Income*, Form 1120, *U.S. Corporation Income Tax Return*, or Form 1120S, *U.S. Income Tax Return for an S Corporation*.

3 IRS, *Tax Gap Map for Year 2001* (Feb. 2007).

4 Unless otherwise indicated, the information in this section is drawn from: IRS response to TAS information request (May 19, 2009).

income, sales (*e.g.*, from sales tax returns), and withholding information. SRFMI data allows the IRS to identify taxpayers who filed a state return but did not file a federal return, or reported income to the state but not to the IRS. The IRS received phase III SRFMI data from 13 states in July 2008 and, as of October 2009, was in the process of filtering it.[5] Between October 2006 and April 2009, the IRS completed 1,231 SRFMI Field examinations. According to the IRS, SRFMI data has enabled it to select returns that are less likely to result in no changes (*i.e.*, lower no-change rates) and more likely to yield higher dollars per hour than returns selected using the IRS's DIF program – its state-of-the-art computer algorithm. The IRS is expecting data from 46 agencies in 44 states as part of a nationwide rollout, beginning in 2010.[6] The IRS may consider expanding SRFMI to bring in more data though the SRFMI process, such as state audit report data (described below).

- *The State Audit Report Program (SARP).* SARP allows the IRS to utilize state audit report information. Fifteen agencies routinely send data to the IRS. Between October 2005 and April 2009, the IRS used SARP data in 6,947 examinations. SARP examinations have generally resulted in lower no-change rates and, with the exception of SB/SE campus examinations, higher dollars per hour than comparable examinations not using SARP data.
- *The Questionable Employment Tax Practices (QETP) Program.* QETP allows the IRS and participating state workforce agencies to exchange employment tax audit reports, audit plans, participate in side-by-side examinations, and collaborate on outreach and educational opportunities. Thirty-five agencies in 34 states participate. Between October 2006 and April 2009, the IRS used QETP data in 3,023 examinations. However, as of fiscal year 2009, these examinations generally resulted in higher no-change rates and lower dollars per hour than comparable examinations not using QETP data.

CONCLUSION

The National Taxpayer Advocate is pleased that the IRS is obtaining more state and local data that it can match against federal income tax reporting. Automating the SRFMI filtering and matching process, however, might allow the IRS to use the data more quickly and efficiently.

With the exception of the QETP program and certain CIPs, specialized examinations using local data generally excel based on traditional examination metrics. However, particularly because these audits might uncover underreported income that would otherwise go undetected, they could have a greater impact on voluntary compliance than examinations selected by other means. Thus, it would be easier for the IRS to justify expanding its use of

5 Government Accountability Office (GAO), GAO-09-45, *IRS Needs to Strengthen Its Approach for Evaluating the SRFMI Data-Sharing Pilot Program* (Nov. 2008) (identifying the 13 states); IRS response to TAS request for data verification (Oct. 2, 2009).

6 IRS response to TAS information request (May 19, 2009) (SRFMI program update as of May 2008); IRS response to TAS information request (May 15, 2009).

this data if it had measures showing the true benefits of these audits, including their impact on voluntary compliance. For example, in 2008 the GAO observed that the SRFMI program lacked measurable objectives.[7]

Because the IRS has little information about the effect of its activities on voluntary compliance, however, it is difficult to develop measures that objectively show whether one examination is better than another. Thus, research to develop practical measures of the impact of an examination utilizing state and local data would be helpful.

In conclusion, the National Taxpayer Advocate offers the following preliminary recommendations:

1. Automate the SRFMI filtering and matching process so the IRS can use the data more quickly and efficiently; and
2. Study the impact on voluntary compliance of examinations that use different types of state and local data, and develop practical measures to evaluate the overall success of these audits on a local basis, as discussed above in connection with CIPs.

IRS COMMENTS

The IRS and various states are currently involved in securely sharing information to maximize voluntary compliance through the State Reverse File Match Initiative (SRFMI) pilot program. In an effort to standardize the data received from states, the Government Liaison and Disclosure (GLD) function created and distributed a comprehensive Specification Book for the states to use in uniformly providing their data to the IRS.

At the outset of the SRFMI pilot, the IRS developed initial automation steps to match and subsequently filter the state data. These processes included Taxpayer Identification Number (TIN) validation, search for compliance with federal filing requirements (nonfilers), and verification of accurate federal reporting for filed returns (underreporters). The IRS systems do not lend themselves to easy and efficient filtering of the volume of SRFMI data with the IRS Master File in the later processes. In early FY 2010, the IRS will add SRFMI data to the Information Returns Master File and Integrated Production Model for access by all functions, such as Examination, Collection, and Criminal Investigation.

The State Audit Report Program (SARP) utilizes state audit report information to make corresponding federal tax assessments. W&I Campus, SB/SE Campus, and Field Examination are continually reviewing the SARP process to improve the timeliness and efficiency of the program.

[7] Although the IRS has stated SRFMI is "securing compliance results to drive business decisions," according to the GAO "[IRS] does not explain what compliance results would be used or what business decisions the compliance results would drive. Nor are the objectives measurable." GAO, GAO-09-45, *IRS Needs to Strengthen Its Approach for Evaluating the SRFMI Data-Sharing Pilot Program* 9 (Nov. 2008).

The Questionable Employment Tax Practices (QETP) program is a partnership between the IRS and state workforce agencies (SWAs). The goal of this program is to leverage scarce enforcement resources and provide a united enforcement framework. Over the last three years, the QETP program has continually increased the number of participating states. There are currently 38 memoranda of understanding (MOUs) with 37 states and the program is still growing. Because of this interest on the part of the states, the IRS established a framework to further develop and modify the program.

Our traditional examination metrics may not always measure the true value of our QETP program. QETP cases generally involve worker classification. As a work stream, worker classification cases result in a higher no-change rate and lower dollars per hour due to the Classification Settlement Program (CSP). In the CSP, taxpayers agree to treat all applicable workers as employees prospectively, a key compliance goal.

Under the CSP, the IRS may mitigate the tax to only one year or 25 percent of one year (*i.e.*, one quarter). Therefore, in a typical three year case (12 quarters), we may assess tax in only four quarters, or in only one quarter for those agreeing to the 25 percent settlement offer (one out of 12 quarters). As a result, the remaining quarters have no-change, hence increasing the no-change rate. In addition, the dollars are less since we are mitigating the tax to four quarters or one quarter when we have audited three years.

To ensure that the IRS achieves its goal of future compliance when mitigating taxes under a CSP agreement, we developed a database to track CSP cases. Annually, the IRS reviews the CSP agreements to ensure that the taxpayers are adhering to the terms of the agreements they made to correctly classify their workers. If it appears that a taxpayer is not in compliance, the case is returned to the field for follow-up by an examiner.

In her report, the National Taxpayer Advocate makes two preliminary recommendations for improving the use of state and local data to maximize voluntary compliance. We are taking or have taken the following actions with respect to these issues:

The IRS is continuing to refine our automated matching and filtering of state data to IRS Master File records. It was necessary to focus our early efforts on adapting the wide variety of state data formats to each of our compliance functions. State statutes frequently mandated particular formats, thus preventing the IRS from establishing uniform requirements. Based on experience and lessons learned in matching and filtering each phase of data received from the states, the IRS modified the automated matching and filtering processes to increase accuracy and timeliness. In addition, to enhance the IRS's functionality, the GLD function has requested the states adjust, as necessary, their methodologies in reporting their respective data.

A comprehensive evaluation plan is being developed for the SRFMI program that will incorporate key features, including measurable objectives, as recommended in the Government Accountability Office report, *IRS Needs to Strengthen Its Approach for*

Evaluating the SRFMI Data-Sharing Pilot Program.[8] We believe it is important to properly document and assess the program as a whole before expanding.

Finally, the IRS, led by Research, Analysis, and Statistics (RAS), has begun a multi-year research initiative to study the impact of service on taxpayer compliance.[9] Since the impact of service must be disentangled from the simultaneous impact of enforcement and other factors, one byproduct of this research may be obtaining plausible estimates of the impact of examinations on compliance. Because of the complexity of this research, the impact of many IRS activities on compliance will be very difficult to quantify. We may be able to estimate the impact of examinations, but it may not be possible to distinguish between examinations based on such things as the types of state and local data used. Nonetheless, one of the benefits of taking a long-term view of this research is that we expect to compile better and more comprehensive data over time, and to improve our estimating methodologies as we learn what works and what does not. Therefore, we expect that our ability to estimate these effects will improve over time.

Taxpayer Advocate Service Comments

While the SRFMI pilot program started slowly, the IRS has improved its procedures for matching and filtering the data it is receiving from the states.[10] If implemented, its plans to add SRFMI data to the Information Returns Master File and Integrated Production Model should help the IRS use the data more quickly and effectively. The IRS's expansion of the QETP program and the program's focus on voluntary compliance (rather than traditional examination metrics) are also a step in the right direction.

In addition, the National Taxpayer Advocate is pleased that the IRS plans to estimate the impact of service on compliance. However, we understand the IRS will not complete this research for five to ten years.[11] The IRS noted, "one byproduct of this research may be obtaining plausible estimates of the impact of examinations on compliance." Thus, it has not committed to study the impact of examinations on compliance. Moreover, it cautioned that it "may not be possible to distinguish between examinations based on such things as the types of state and local data used." The IRS cannot effectively maximize the impact of examinations on its goal of improving voluntary compliance without *actionable* information regarding which examinations have the greatest impact. As the IRS points out, traditional

8 GAO, GAO-09-45, *IRS Needs to Strengthen Its Approach for Evaluating the SRFMI Data-Sharing Pilot Program* (Nov. 2008).

9 Initially approved in the FY 2008 budget.

10 As of May 15, 2009, SRFMI data was not available for use by the Areas in formulating compliance initiative projects. Response to TAS information request (May 15, 2009).

11 Response to TAS information request (June 17, 2009).

examination metrics are not well suited to measure the impact of certain examinations, particularly QETP program examinations. Thus, it is important for the IRS to design the research to answer such basic questions as which examinations are most effective in improving voluntary compliance.

Recommendations

The National Taxpayer Advocate offers the following recommendations:

1. Design research to yield actionable information about the impact of examinations on voluntary compliance (*e.g.*, whether using state and local data increases the impact of examinations on voluntary compliance); and
2. Develop practical measures (or analysis) for use in evaluating the overall success of audits using state and local data, as discussed above in connection with CIPs.

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

RESPONSIBLE OFFICIALS

Chris Wagner, Commissioner, Small Business/Self-Employed Division
Richard E. Byrd Jr., Commissioner, Wage and Investment Division
Terry Milholland, Chief Technology Officer, Management and Information Technology Services

DEFINITION OF PROBLEM

A comprehensive database containing all data relating to gross receipts could help the IRS improve its system of selecting returns for examination and overall audit efficiency. Because no such database exists, the IRS has room to improve its ability to detect unreported income – the largest component of the tax gap.[1]

ANALYSIS OF PROBLEM

Background

The National Taxpayer Advocate recommended the IRS combine all of the gross receipts information received from third parties into a single database.[2] For example, the database could include income reported on Forms 1099, *U.S. Information Return*, credit card information reports (when available), state and local data (*e.g.*, sales tax data), 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, along with other sources.[3] The IRS could use the income database to detect potential underreporting of income as well as nonfiling. An ideal system would support the automated identification of returns with underreported gross receipts, and provide IRS examiners with easy access to gross receipts information to develop cases. Examiners should have sufficient information to determine why a return was selected and to help them identify unreported income on returns selected for any reason.

What the IRS is doing

The IRS agreed with the suggestion in the National Taxpayer Advocate's 2007 Annual Report that "multiple forms of gross receipt information need to be electronically accessible

1 IRS, *Tax Gap Map for Year 2001* (Feb. 2007).

2 *See, e.g.*, National Taxpayer Advocate 2007 Annual Report to Congress 64 (recommendation 5).

3 While IRC § 6103 may prohibit Title 31 BSA examiners from accessing tax return information, IRS databases can obviously be structured to comply with IRC § 6103 without limiting access of tax examiners to Title 31 information.

to properly address underreporting and non-reporting during selection, classification, matching, and examination processes."[4] It plans to make a wide variety of receipt-related data available through two systems: the Compliance Data Environment (CDE) and the Integrated Production Model (IPM).[5]

CDE, which the IRS piloted in May 2008, contains tax return data for the most current four years. It can use this data to identify, classify, and deliver returns for examination.[6] Once a return is identified, CDE can also retrieve external receipt-related information with respect to it, such as currency and banking information (*e.g.*, Currency & Banking Retrieval System (CBRS) data), third party information returns (*e.g.*, Form 1099 data), and asset information (*e.g.*, data from Choicepoint). An examiner may use this information to classify the returns and for case building. Because this receipt-related information is not contained in CDE, however, CDE cannot use it to identify returns. For this reason, the IRS has concluded CDE "would not be a good source for identifying returns with likely unreported income other than returns showing expenses in excess of income."[7]

By contrast, IPM can identify returns based on a wider range of receipt-related data than CDE. The IRS plans to use IPM as a central repository for current and historical tax return and tax account information. IPM pulls data, including receipt-related data, from multiple databases, and the IRS plans to populate IPM with more third-party payer information in FY 2010.[8] IPM will include Information Return Document Matching (IRDM) data (including merchant payment card reporting, securities basis reporting, and government payment withholding information) as it becomes available.

The IRS can or will store additional gross-receipts-related data from the states on CDE or IPM, as follows.[9]

- State Reverse File Matching Initiative (SRFMI) data will be available on IPM as soon as the IRS filters it;

4 National Taxpayer Advocate 2007 Annual Report to Congress 50 (IRS comments).

5 Unless otherwise indicated, the information in this section regarding CDE and IPM is drawn from: IRS response to National Taxpayer Advocate recommendations, JAMES A6, TAS-07-ARC-001MSP (Sept. 23, 2008); IRS response to TAS information request (May 19, 2009); and IRS response to TAS information request (Oct. 22, 2009).

6 The process of selecting returns for examination involves (1) identifying returns, and (2) manually "classifying" them to determine if they are worth examining.

7 IRS response to TAS information request (May 19, 2009).

8 These databases include: Individual Master File (IMF), Employee Tax Examination Program (ETEP), Audit Information Management System (AIMS), Research, Business Master File (BMF), Business Return Transaction File (BRTF), Payer Master File (PMF), Aggregated Information Return (AIR), Information Return Master File (IRMF), Employee Plan Master File (EPMF), Combined Annual Wage Reporting (CAWR) system, and Data Master One (DM–1) File, SS8 Integrated Case Processing (SS8ICP), United States Post Office (USPS) and the U.S. Census Bureau. Integrated Production Model (IPM), Release 5, Milestone 3/4A, *Privacy Impact Assessment* (July 1, 2009), http://www.irs.gov/pub/irs-pia/ipm-pia.pdf.

9 For a discussion of this data, see Most Serious Problem, *The IRS Does Not Know if It Is Using State and Local Data Effectively to Maximize Voluntary Compliance, supra.*

- State Audit Report Program (SARP) data could theoretically be placed on IPM or CDE, if the states would provide it in a compatible electronic format;[10] and
- The IRS's Bank Secrecy Act Program (BSA) receives information from the states, including state Money Service Business (MSB) audit information, to identify and select Bank Secrecy Act and Form 8300 examination cases, and stores the information in the CBRS and CDE (but not IPM). [11]

In addition, Questionable Employment Tax Practices (QETP) program data may be available in future versions of the Servicewide Employment Tax Research System (SWETRS), a computer application that draws information from IPM.

CONCLUSION

If implemented, the IRS's plan to incorporate much of its receipt-related data, such as third party information reporting and SRFMI data into CDE and IPM is an important step that could help improve audit selection and case building. However, some receipt-related data will still not be available through these or any other comprehensive "income database." As the IRS adds data to IPM, it may need to update applications that access the new IPM data.

In conclusion, the National Taxpayer Advocate offers the following preliminary recommendations:

1. Add more receipt- and asset- related data (such as SRFMI , SARP, or BSA data) to IPM; and
2. Create or modify applications to access IPM data so the IRS can use the data for both income tax return selection and case building.

IRS COMMENTS

The IRS agrees that providing access to third-party information reporting improves audit selection and case building. Accordingly, our data strategy is to continue developing IPM[12] and expanding its utility and customer base as funding and resources allow.

We intend to accomplish the following:

10 According to the IRS, the states currently do not have systems in place to provide SARP data electronically. IRS response to TAS information request (May 19, 2009).

11 There are other small databases maintained throughout the IRS, which contain potentially relevant information. For example, the Offshore Credit Card Project (OCCP) Database contains information received from summons issued to financial institutions, credit card companies, and third party processors of financial information that may identify individuals who are illegally sheltering money offshore. IRS, *As-Built Architecture (ABA)* (Apr. 30, 2009).

12 Information in IPM currently includes: Individual Master File (IMF), Employee Tax Examination Program (ETEP), Audit Information Management System (AIMS), Research, Business Master File (BMF), Business Return Transaction File (BRTF), Payer Master File (PMF), Aggregated Information Return (AIR), Information Return Master File (IRMF), Employee Plan Master File (EPMF), Combined Annual Wage Reporting (CAWR) system, and Data Master One (DM–1) File, SS8 Integrated Case Processing (SS8ICP), United States Post Office (USPS) and the U.S. Census Bureau.

Additional Data: Adding more receipt and asset-related data to IPM as it becomes available.[13] More data elements will be added to enhance the use and access of data across the IRS. Looking to the future, we have a team currently studying how to electronically incorporate data from our foreign exchange partners into IPM for utilization in the Automated Underreporter (AUR) process.

New Clients: Maintaining service to our existing clients and expanding our client base. At present, IPM services two clients.[14] Several additional applications will become clients of IPM in the future. IPM saves new projects from expending resources to develop separate redundant databases. Future potential clients will require funding to develop the remaining components of their applications.

Introduce Functionality: IPM will permit the use of business intelligence tools to access and analyze IPM data.[15] This permits performance reporting including an interactive analysis of trends, provides for informed operational decision-making, and provides forecasting models. Adding functionality will necessitate additional costs for programming, software, personnel and security.

Improved data availability and functionality will permit the IRS to expand the use of IPM beyond case selection and inventory analysis to include case building. It will also provide the IRS new information required to improve our ability to select returns for examination and overall audit efficiency.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate applauds IRS plans to incorporate state income tax, sales tax, and similar State Reverse File Matching Initiative (SRFMI) data into the IPM database and its efforts to incorporate data from foreign exchange partners into IPM. She is also pleased that IRS computer applications use the data on IPM to identify nonfilers and select employment tax returns for examination. However, IPM would be more useful as an income database if it incorporated more income-related information. To be more useful in detecting unreported income, this data must be used in the IRS algorithms that perform automated income tax return selection (or at least ad hoc queries), and by IRS examiners for building cases. To reach this goal, the IRS comments suggest it may need to modify

13 IPM already stores third-party data including address and individual information from the Social Security Administration (SSA), Health and Human Services (HHS), Employee Plans Information, Information Returns data, case information, large dollar cash transaction data, and North American Industry Classification Code System (NAICS) data from the Census Bureau. Future versions will expand to include additional information return data and state data (via incorporating SRFMI). SRFMI data incorporated into IRMF will also include information, as available, regarding other state taxes that are sales-related or indicative of income (sales tax, hotel occupancy tax, occupational taxes, etc.).

14 These are Business Master File Case Creation Non-Filer Identification Process (BMF CCNIP) and SWETRS. BMF CCNIP utilizes tax return information and payor/payee information derived from the IRMF to prioritize case BMF non-filer casework. SWETRS is an automated system utilizing IRMF, and other, data to automate the case selection process for employment tax examinations.

15 For example, Business Objects is a web-enabled planning analysis and decision support application, which is useful for ad hoc query and data reporting. Business Objects gives users the ability to explore and interact with data more freely.

computer applications and add functionality to IPM. These comments also suggest that adding applications and functionality to IPM may require additional funding. If funding presents a roadblock, the IRS should specifically identify any such needs and make appropriate budget requests, which the National Taxpayer Advocate would support.

Recommendations

The National Taxpayer Advocate offers the following recommendations:

1. Add more receipt- and asset- related data to IPM, such as
   - State Audit Report Program (SARP) data;
   - Cash payments (*i.e.*, Bank Secrecy Act Program (BSA) data);
   - Taxpayer bank account data; and
   - Credit card information reporting data (when available).
2. Create or modify applications to access IPM data so the IRS can use the data for both automated income tax return selection and case building.

MSP #12

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

RESPONSIBLE OFFICIALS

Chris Wagner, Commissioner, Small Business/Self-Employed Division
Richard E. Byrd Jr., Commissioner, Wage and Investment Division

DEFINITION OF PROBLEM

Specialized examiners who focus on detecting unreported income conduct an insignificant number of examinations. As a result, there is room for improving the IRS's ability to detect unreported income – the largest component of the tax gap.[1]

ANALYSIS OF PROBLEM

Background

A group of specialized auditors focused on detecting the omission of gross receipts not subject to third party information reporting could, over time, become more effective and efficient in detecting them, especially if they have access to a comprehensive income database (described above).[2] The unit could supplement local compliance initiative projects (CIPs) and industry specific initiatives to address noncompliance in the cash economy. Taxpayers report on their returns more than 95 percent of all income that is subject to substantial third party information reporting, as compared to less than 50 percent of the income not subject to it.[3] Thus, the unit's enhanced ability to detect unreported receipts that are not subject to information reporting could have a significant indirect effect on compliance.

What the IRS is doing

The IRS expects all of its examiners to detect unreported receipts,[4] and generally trains them how to do so. However, the Small Business/Self-Employed (SB/SE) division has specialized programs to detect unreported receipts, including:[5]

1 IRS, *Tax Gap Map for Year 2001* (Feb. 2007).

2 The Government Accountability Office (GAO) found ten percent of sole proprietors with understated taxes account for 61 percent of the total understated tax liability attributable to sole proprietors. GAO, GAO-07-1014, *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance* 15 (July 2007). Thus, such audits could be productive if properly targeted.

3 *See* IRS, *Tax Gap Map for Year 2001* (Feb. 2007).

4 IRS response to National Taxpayer Advocate recommendations, JAMES A6, TAS-07-ARC-001MSP (Sept. 23, 2008) ("All examination employees are considered to be specialists in the identification and detection of unreported income.").

5 IRS response to TAS information request (May 15, 2009).

- *The Special Enforcement Program (SEP).* SEP works closely with law enforcement officials in focusing on taxpayers who *intentionally* understate significant tax liabilities from legal or illegal activities.[6] The SEP obtains leads from various sources, including informants, federal, state or local law enforcement agencies, court documents, public databases, newspaper articles, the Internet, etc.[7] In FY 2008, all of the SEP groups combined closed 6,825 examinations.[8] However, this figure includes examinations involving issues other than unreported income.
- *The Abusive Transaction Program (ATP).* ATP has revenue agents (auditors) whose specialty is identifying unreported income from abusive offshore transactions. One of the ATP's seven teams executes the Offshore Compliance Initiative Program (OCI). The IRS created the OCI to extend the success of the Offshore Credit Card Program (OCCP), which sought to identify taxpayers who use credit or debit cards to access untaxed funds in offshore accounts. ATP agents have access to applications that show business relationships and ownership of assets in an attempt to identify potential sources of unreported income. In FY 2008, SB/SE closed examinations of approximately 2,700 tax years relating to offshore work.[9] However, this figure also includes many examinations involving issues other than unreported income.

CONCLUSION

While all examination employees need some ability to detect unreported receipts, it will be very difficult for all examination employees to be specialists in detecting them. Unlike other examiners who may spend their days on issues involving the Alternative Minimum Tax (AMT), innocent spouse, EITC, accelerated depreciation, and installment sales, true specialists would focus primarily, if not solely, on unreported income. The IRS recognized the value of such specialization when it created the SEP and ATP groups.

However, these groups conduct relatively few examinations. Correspondence examinations, which cannot detect unreported income as effectively as face-to-face audits, accounted for almost 82 percent of the examinations of individuals in FY 2008.[10] All of the SEP and ATP groups combined closed fewer than 9,525 examinations in FY 2008 – only 0.62 percent of the total – and not all of these focused on unreported income,[11] which is

6 *See* IRM 4.16.1(1) (Jan. 1, 2003). Detecting unreported illegal-source income is a primary focus for SEP agents. *See* IRM 4.16.1.6 (Jan. 1, 2003).

7 *See, e.g.*, IRM 4.16.1.4.2 (Jan. 1, 2003).

8 IRS response to TAS information request (June 15, 2009) (A-CIS data reflecting all SEP closures). By comparison, the IRS closed 1,540,771 examinations in FY 2008. IRS Pub. 55B, Data Book, *Table 9a* (2009).

9 IRS response to TAS information request (June 16, 2009).

10 Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2009-30-082, *Trends in Compliance Activities Through Fiscal Year 2008* (June 10, 2009).

11 The 0.62 percent figure is computed by dividing 9,525 (2,700 ATP + 6,825 SEP) by 1,540,771 total exams. IRS response to TAS information request (June 15, 2009) (6,825 SEP closures in FY 2008); IRS response to TAS information request (June 16, 2009) (fewer than 2,700 ATP exam closures in FY 2008); IRS Pub. 55B, Data Book, *Table 9a* (2009) (1,540,771 exam closures in FY 2008).

the largest component of the tax gap.[12] In addition, these groups do not have access to a database that aggregates all of the IRS's receipt-related information.

In conclusion, the National Taxpayer Advocate offers these preliminary recommendations:

1. Create a specialized unit (or expand existing groups) to focus on detecting unreported gross receipts by taxpayers whose income is not subject to information reporting; and
2. Give the specialized unit access to a more comprehensive income database, as described above.[13]

IRS COMMENTS

The IRS agrees that detection of unreported income is key to reducing the tax gap. As such, we set expectations for all examiners to detect unreported income during examinations, when warranted. We continually reinforce their technical skills and knowledge through ongoing training and managerial guidance with the goal that all examiners have a level of skill in income determinations. This is necessary to complete a quality examination while achieving balanced coverage and is the only way to uncover unreported income over the broad spectrum of our taxpayer base.

To successfully address our goal of a workforce trained in unreported income detection, in addition to general training in this area, the IRS has implemented Examiner's Toolkit training for all field examiners and managers which specifically focuses on identifying unreported income. This supplemental training equips our examiners and managers with the tools needed to identify and properly develop income issues.

To augment the training and expectations we have for all of our examiners, we also have specialist examiners as mentioned in the National Taxpayer Advocate's report. The Special Enforcement Program, Abusive Transaction Program, and Offshore groups were created to address the complex nature of these more sophisticated cases and to dedicate resources to do this type of work. The IRS agrees that there would be a benefit in expanding existing SEP groups to focus on detecting unreported gross receipts by taxpayers whose income is not subject to information reporting.

As stated in the National Taxpayer Advocate's report, the SEP works closely with law enforcement officials in focusing on taxpayers who intentionally understate significant tax liabilities from legal or illegal activities. The SEP obtains leads from various sources, including informants, federal, state or local law enforcement agencies, court documents, public databases, newspaper articles, and the Internet.

12 IRS, *Tax Gap Map for Year 2001* (Feb. 2007).

13 The IRS should not authorize the same employee to both select a return for examination and conduct the examination. We also do not suggest that these groups should ignore issues other than unreported income on returns they are examining.

In FY 2009 and continuing in 2010, the SEP is focusing its efforts on addressing specific types of egregious activities that substantially under report income. Ongoing initiatives such as the Whistleblower and Suspicious Activity Report projects are in process to address underreporting of income.

In addition, a court-approved John Doe summons was served by IRS on a Swiss bank. The purpose of this summons is to identify high income, high wealth individuals with unreported income that has been secreted offshore. In FY 2009, a summons enforcement action was settled with an agreement by the bank to provide thousands of U.S. taxpayer names and account information to the IRS. We identified senior examiners and provided specialized training to assist our Offshore and SEP groups with examining these taxpayers. The IRS recently closed an offshore voluntary settlement initiative that provided taxpayers with the ability to file amended returns for the prior six years and pay all taxes and interest along with a fixed penalty. We expect thousands of taxpayers with unreported income to come in under this initiative.

The National Taxpayer Advocate makes two preliminary recommendations to improve the detection of the omission of gross receipts. We are taking or have taken the following actions with respect to these issues:

We agree expanding existing groups would benefit the IRS efforts to detect unreported income and is in line with our current planned initiatives. In FY 2009, nine new specialized groups were established to focus on offshore activities. In FY 2010, additional resources have been allocated for five newly created offshore groups and to expand the SEP. These additional resources are included in the proposed FY 2010 work plan. Due to the nature of these groups, and the fact that all examiners are trained to recognize and develop unreported income issues, we do not believe there is a need for the creation of an additional type of specialized unit.

We agree that providing examiners access to a more comprehensive income database would be beneficial. However, the benefit of a database, such as is described in the National Taxpayer Advocate's report,[14] must be weighed against the potential significant cost and the relative benefit as compared to other information technology projects. Taxpayer privacy and data security must also be a consideration. As they become available, we will continue to provide our examiners with the tools necessary to effectively perform their jobs while ensuring proper safeguard of taxpayer privacy and information.

[14] See *The IRS Lacks a Comprehensive "Income" Database that Could Help Identify Underreporting and Improve Audit Efficiency, supra.*

Taxpayer Advocate Service Comments

The IRS's efforts to train field examiners to identify unreported income are a step in the right direction. However, a typical examination (particularly a typical correspondence examination) is not as effective in this regard as an examination by a specialized examiner focusing on unreported income.[15]

The National Taxpayer Advocate applauds IRS plans to allocate more resources to SEP groups.[16] However, when we consider that unreported income is the single largest component of the tax gap, more than 80 percent of all individual examinations are conducted by correspondence, and less than one percent are conducted by specialized groups, the proposed increase may not be adequate.[17] Moreover, the SB/SE Operating Division is losing the examiners in its Offshore group, who are being transferred to International Compliance Strategy & Policy Operations in the Large and Mid-Size Business (LMSB) division.[18] While the IRS may increase the resources devoted to its Offshore groups, this reorganization could potentially reduce the resources devoted to detecting unreported income by domestic businesses operating in the cash economy.[19]

As noted above, the SEP group focuses on intentional underreporting of legal and illegal income (*i.e.*, fraud) and the Offshore group focus on taxpayers with a connection to offshore transactions.[20] Thus, without an expansion in scope, these groups will not address income unreported by taxpayers whose intent is difficult to prove and who do not have an offshore connection.

In addition, the IRS comments note that information obtained from foreign banks, whistleblowers, and Suspicious Activity Reports from financial services businesses can help the IRS identify and address underreported income. This and other similar information will be useless if the IRS does not devote sufficient resources to using the data. Moreover, the data

15 The IRS Commissioner recently announcing the formation of the Global High-Wealth Industry group to get an "economic picture of the enterprise controlled by the wealthy individual." Douglas H. Shulman, *Prepared Remarks Before the AICPA National Conference on Federal Taxation* (Oct. 26, 2009), *reprinted as, Shulman Says IRS to Increase Enforcement Efforts*, 2009 TNT 205-22 (Oct. 27, 2009). He explained: "We cannot do this by continuing to approach each tax return in the enterprise as a single and separate entity. We must understand and analyze the entire picture." The same is true for domestic taxpayers.

16 According to the IRS, the draft FY 2010 Exam Plan allows for an increase in SEP "non-case time" of 16.25 staff years. IRS response to TAS information request (Nov. 16, 2009). The IRS has also made progress in obtaining information from a foreign bank where some U.S. taxpayers might be holding unreported income. However, its SEP and Offshore groups needed assistance from 200 senior examiners in different groups who required special training to handle examinations from this single lead. IRS response to TAS information request (Nov. 17, 2009).

17 *See, e.g.*, TIGTA, Ref. No. 2009-30-082, *Trends in Compliance Activities Through Fiscal Year 2008* (June 10, 2009) (correspondence examination figures); IRS response to TAS information request (June 15, 2009) (SEP figures); IRS response to TAS information request (June 16, 2009) (ATP figures); IRS Pub. 55B, Data Book, *Table 9a* (2009) (total examination figures); IRS, *Tax Gap Map for Year 2001* (Feb. 2007) (tax gap figures).

18 IRS response to TAS information request (Nov. 10, 2009).

19 According to the IRS, the draft SB/SE FY 2010 Examination Plan included 70 hires for the Offshore groups before they were transferred to LMSB. IRS response to TAS information request (Nov. 16, 2009).

20 If there is no offshore connection, the Offshore group will not be involved. IRS response to TAS information request (Nov. 13, 2009). The IRS does not set return closure goals for the SEP group because this practice would imply a quota in fraud cases. IRS response to TAS information request (Nov. 16, 2009). Thus, the SEP groups focus on fraud cases.

must be available to the right IRS employee at the right time. For this reason, an income database could help the IRS use this valuable information more effectively.

Finally, there is no stronger advocate of taxpayer privacy and information security than the National Taxpayer Advocate. Most of the information proposed to be included in an income database is already in smaller databases scattered throughout the IRS. Centralizing the data could make it more secure without raising new privacy concerns. Further, to do its job the IRS must process very sensitive financial information on a regular basis. If there are real privacy or security concerns, the IRS should specifically identify and address them.[21]

Recommendations

The National Taxpayer Advocate offers the following recommendations:

1. Create a specialized group (or expand the size and scope of existing groups) to focus on detecting unreported gross receipts by taxpayers whose income is not subject to information reporting without regard to the offshore or intentional aspects of any underreporting; and
2. Provide these specialized groups access to information that would be available in the "income" database proposed above.[22]

21 We discuss database issues above. *See The IRS Lacks a Comprehensive "Income" Database that Could Help Identify Underreporting and Improve Audit Efficiency, supra.*

22 This group should have access to all available information potentially relevant to unreported income, which may include the Offshore Credit Card Project (OCCP) Database, state and local data, such as State Reverse File Matching Initiative (SRFMI) and State Audit Report Program (SARP), Bank Secrecy Act Program (BSA) data, and other data contained in IRS systems such as the Integrated Production Model and Compliance Data Environment, as discussed above. See *The IRS Lacks a Comprehensive "Income" Database that Could Help Identify Underreporting and Improve Audit Efficiency, supra.*

MSP #13

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

RESPONSIBLE OFFICIALS

Chris Wagner, Commissioner, Small Business/Self-Employed Division
Richard E. Byrd Jr., Commissioner, Wage and Investment Division

DEFINITION OF PROBLEM

Adding a line to Schedule C to break out income not reported on Forms 1099 could improve voluntary compliance, audit selection, and efficiency. Adding two checkboxes to business tax returns to highlight information reporting requirements could have a similarly positive effect. It could reduce inadvertent failures to file information returns. Because the IRS has declined to make these simple changes, it is not maximizing voluntary compliance.

ANALYSIS OF PROBLEM

Background

Revising Form 1040, Schedule C, Profit or Loss from Business (Sole Proprietorship).

Sole proprietors report their business income by attaching Schedule C to their returns. Adding a line to Schedule C so that taxpayers separately report (1) the amount of income reported on Forms 1099, *U.S. Information Return*, and (2) other income not reported on Forms 1099 could improve voluntary compliance, audit selection, and efficiency.

This change would encourage taxpayers to report income even if it is not subject to information reporting. Some cash businesses would hesitate to report they received no income other than amounts subject to information reporting. Moreover, this change would allow the IRS to match the income reported on Schedule C with income reported on Forms 1099 and other information returns. It would also improve an auditor's ability to detect unreported income.

Revising business income tax return forms to highlight information reporting requirements.

The National Taxpayer Advocate also recommended requiring 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. A taxpayer who did not file a required Form 1099 would have to either confess the failure or make an affirmative misstatement on his or her return, an act that could not be excused or rationalized as an innocent omission. As noted above, receipts reported to the IRS on information returns are much more likely to be reported on the payees' income tax returns.[1] Thus, increased information reporting compliance should prompt contractors (payees) to report more of their income.[2]

What the IRS is doing

In its response to the National Taxpayer Advocate's 2007 recommendation to revise Schedule C, the IRS indicated it "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." It also agreed that the recommendation to revise business tax returns could have "a positive impact on compliance activities ... [and] improve transparency and potentially reporting compliance."[3] However, it did not agree to either suggestion for changing the forms, citing the need to consider "the impact to taxpayer burden and additional costs for transcription."[4]

More recently, the IRS indicated it might revise Schedule C in connection with other revisions needed to address new credit card information reporting requirements.[5] It was less inclined to consider revising its business tax returns, as we suggested, stating:

> A similar requirement was included on Form 1120 until 1980, but was removed because: (a) taxpayer burden (b) the question did not improve compliance, and (c) it has been the IRS's experience that taxpayers provide the most favorable answer, regardless of whether they completed what was asked of them.[6]

However, the checkbox included on Form 1120 before 1980 was one question in a long list of checkboxes and did not educate taxpayers about when a Form 1099 is appropriate by highlighting the $600 threshold.[7] Moreover, this checkbox was not included on Schedule C, which is filed by sole proprietors, who may be the taxpayers most likely to benefit from it.

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1 *See* IRS, *Tax Gap Map for Year 2001* (Feb. 2007) (showing that taxpayers report on their returns more than 95 percent of all income that is subject to substantial third party information reporting, as compared to less than 50 percent of the income not subject to it).

2 In 2009, the Government Accountability Office (GAO) observed that California uses such a checkbox and made a similar recommendation to the IRS. *See* GAO, GAO-09-238, *IRS Could Do More to Promote Compliance by Third Parties with Miscellaneous Income Reporting Requirements* 26 and 37 (Jan. 2009).

3 National Taxpayer Advocate 2007 Annual Report to Congress 51.

4 *Id.* at 51, 58.

5 IRS response to TAS information request (May 15, 2009).

6 IRS response to National Taxpayer Advocate recommendations, Joint Audit Management Enterprise System (JAMES) A6, TAS-07-ARC-001MSP (Sept. 23, 2008).

7 Form 1120, *U.S. Corporation Income Tax Return* (1979) (Schedule K, *Record of Federal Deposit Forms 503*, Item M asked: "Did you file all required Forms 1087, 1096, and 1099?").

CONCLUSION

The IRS has had four years to weigh the burdens and benefits of these form changes, which the National Taxpayer Advocate proposed in 2005.[8] Any burden associated with these changes should be minimal since the law already requires taxpayers to add up the income shown on any information returns to compute their taxable income. The two checkboxes we suggested adding to business returns should be even less burdensome for taxpayers. According to the IRS, transcribing a new line on Schedule C would cost about $1,041,099 per year.[9] These costs should decline as taxpayers increasingly file electronically.[10]

The IRS's conclusion that the pre-1980 question highlighting Form 1099 filing requirements did not improve compliance is not based on data that it has cited, and conflicts with the IRS's reasonable assessment that the change may have a positive impact on compliance. Moreover, transcription costs and taxpayer burden seem relatively small in light of potential compliance gains.

In conclusion, the National Taxpayer Advocate's preliminary recommendation is to revise Form 1040, Schedule C, *Profit or Loss from Business (Sole Proprietorship)*, and business tax returns to promote voluntary compliance and audit efficiency, as described above.

IRS COMMENTS

The IRS agrees that underreported income presents compliance challenges and is committed to improving current compliance levels in accordance with our tax gap strategy. In 2008, Congress enacted a number of provisions to enhance tax filing accuracy, including new information reporting requirements that were included in prior years Presidential budget requests, and prior revenue proposals to address the Tax Gap. The Information Reporting and Document Matching (IRDM) team is responsible for implementing the credit card and basis reporting statutes including new regulations, new or revised forms and publications, and information technology projects. This is a broad, cross-functional team that includes personnel from the Small Business/Self Employed, Wage & Investment, Large and Mid-Size Business, and Tax Exempt/Government Entities divisions; TAS; and Modernization and Information Technology Service.

The IRS concurs with the National Taxpayer Advocate's report that revising the Schedule C to break out income not reported on Forms 1099 may have a positive impact on compliance. Similarly, we concur that adding two checkboxes to business tax returns to highlight information reporting requirements would have a positive effect if they in fact resulted in reducing inadvertent failures to file information returns. The IRDM team is in the process

8 *See, e.g.*, National Taxpayer Advocate 2005 Annual Report to Congress 67-68. The IRS did not provide any analysis of taxpayer burden associated with the National Taxpayer Advocate's recommendation. IRS response to TAS information request (May 15, 2009).

9 IRS response to TAS information request (May 15, 2009).

10 About 58.7 percent of all Schedule C filers (13,151,316 out of 22,419,953) submitted returns electronically in tax year 2007. IRS Compliance Data Warehouse (July 29, 2009).

of identifying form and schedule changes necessary to effectively capture the new information reporting data, including the Form 1040, Schedule C as well as all other business returns. However, any changes must weigh the compliance benefit against taxpayer burden and additional costs for transcription (as previously discussed in our response to the same recommendations in the National Taxpayer Advocate's 2005 and 2007 Annual Reports to Congress).

The National Taxpayer Advocate makes one preliminary recommendation to improve voluntary compliance and increase audit efficiency. We are taking or have taken the following actions with respect to this recommendation:

The IRDM team is identifying revisions to the Form 1040, Schedule C, and other business tax returns to address the recent information reporting legislation. Revised forms and schedules will be fully vetted with internal and external stakeholders. Recognizing the burden and costs that form and schedule revisions generate, our goal is to balance effective implementation and administration of new tax legislation with the burden (both internal and external) of form or schedule changes. Any revisions would likely take effect for Processing Year 2012, incorporating legislative changes through tax year 2011.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS has created an Information Reporting and Document Matching (IRDM) team, which includes a TAS representative. If we understand the comments correctly, however, the IRS has not agreed to adopt the recommended form changes without additional analysis of burdens and benefits, nor to complete any such analysis. We encourage the IRS to reconsider this position in light of its acknowledgement that the proposed form changes may have a positive effect on compliance, and its inability to identify any significant cost for the IRS or significant burden on taxpayers.

Recommendations

The National Taxpayer Advocate offers the following recommendations:

1. Set a date by which the IRS will complete any analysis of the benefits and burdens of the simple form changes (described above) that it deems necessary; and
2. Unless the IRS shows the burdens of these form changes outweigh the benefits, set a date by which it will implement them.

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

RESPONSIBLE OFFICIAL

Chris Wagner, Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

The underutilization of offers in compromise (OICs) as a viable collection alternative directly conflicts with both the IRS's policy statement for the OIC program and Congress's intent for its use.[1] The IRS data on OICs speaks for itself:

- The number of offers the IRS has accepted has declined by 72 percent from Fiscal Year (FY) 2001 to FY 2009.[2]
- Revenue recovered through OICs has dropped by 54 percent since FY 2001.[3]
- The IRS Office of Appeals, rather than the Collection function, took in 45 percent of all the OIC dollars collected in FY 2009.[4]
- The number of offers received has increased by 18 percent in FY 2009 over FY 2008, while the number of offers accepted has declined in the same period.[5]
- Three out of every four offers disposed of in FY 2009 were returned, rejected, withdrawn, or terminated.[6]
- A taxpayer must complete over 100 steps to apply for an OIC.[7]

1 Internal Revenue Manual (IRM) 1.2.14.1.17 (Jan. 30, 1992); IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206 (1998); H.R. Conf. Rep. 599, 105th Cong., 2d Sess., 289 (1998).

2 IRS, Collection Activity Report NO-5000-108, *Monthly Report of Offer in Compromise Activity (FY 2001-FY 2008)*; IRS, Collection Activity Report NO-5000-108, *Monthly Report of Offer in Compromise Activity* (Sept. 30, 2009). The IRS accepted 38,643 OICs in FY 2001 and 10,665 in FY 2009.

3 *Id.* In FY 2001, the IRS collected nearly $341 million through OICs but only collected slightly over $157 million in FY 2009.

4 IRS, Collection Activity Report NO-5000-108, *Monthly Report of Offer in Compromise Activity* (Sept. 30, 2009). OIC collections totaled slightly over $157 million in FY 2009; of this amount, OIC collections by Appeals were slightly over $70 million.

5 IRS, Collection Activity Report NO-5000-108, *Monthly Report of Offer in Compromise Activity* (Sept. 30, 2009); IRS, Collection Activity Report NO-5000-108, *Monthly Report of Offer in Compromise Activity* (Sept. 30, 2008). For FY 2009, the IRS received 52,102 offers compared to 43,989 in FY 2008. Moreover, the IRS accepted 10,665 offers in FY 2009 compared to 10,677 in FY 2008.

6 IRS, Collection Activity Report NO-5000-108, *Monthly Report of Offer in Compromise Activity* (Sept. 30, 2009). In FY 2009, the IRS disposed of a total of 43,211 offers of which 4,384 were closed as not processable returns, 12,621 as rejections, 10,529 as processable returns, 5,012 as withdrawals or terminations, and 10,665 as acceptances.

7 Siegel & Gale, *Offer in Compromise, Strategic Recommendations* 10-13 (July 31, 2009).

- The IRS's "second level" review of rejected OICs, established to reconsider whether valuations are accurate in the current economy, has reviewed only seven offers, accepting just one;[8] and
- The IRS has committed nearly 55 percent fewer Collection staff hours to the OIC program in FY 2009 than in FY 2001.[9]

All of this information is particularly troubling given that the IRS reported almost $26 billion as currently not collectible (CNC) in FY 2009, and maintains a CNC inventory of nearly $61 billion (representing over 2.8 million taxpayers) and a large inventory of "inactive" cases in its queue.[10]

After receiving recommendations for change and improvement from the National Taxpayer Advocate over the past eight years, the IRS has recently taken steps to evaluate the OIC program.[11] The IRS has engaged consultants to study the OIC application process and the causes for the change in receipts, and to develop a strategy for the IRS to simplify communication with taxpayers who are OIC candidates.[12] While the National Taxpayer Advocate applauds these efforts, she remains concerned that these steps will not reform the OIC program sufficiently to convince taxpayers that the offer is a viable alternative in the IRS's collection strategy, rather than a separate program designed for only a select few.

ANALYSIS OF PROBLEM

Background

An OIC is an agreement between a taxpayer and the government where the government accepts payment of less than the full amount owed in exchange for the taxpayer's promise

8 Small Business/Self-Employed (SB/SE) Division, Interim Guidance for Additional Review of Real Property Valuations in Offer in Compromise Cases (Feb. 2, 2009); SB/SE response to TAS research request (July 20, 2009).

9 IRS, Collection Activity Report NO-5000-C23, *Collection Workload Indicators Reports* (FY 2001 and FY 2009); SB/SE response to TAS research request (Oct. 29, 2009).

10 IRM 5.16.1.1 (May 5, 2009). IRS Policy Statement P-5-71 provides the IRS authority to report an account as CNC for a variety of reasons (*e.g.*, unable to pay, unable to contact or locate, and death). This generally suspends collection actions but the liability is still due and owing; thus, penalties and interest continue to accrue until the statutory period of collection expires. IRS, Collection Activity Report NO-5000-149, *Recap of Accounts Currently Not Collectible Reports* (Oct. 1, 2009). The IRS Collection queue is an inventory of cases awaiting assignment to the Collection Field function. While these cases are considered to be "open" collection accounts, they remain inactive until assigned to a revenue officer. At the conclusion of FY 2009, the IRS reported 3,665,474 Taxpayer Delinquent Accounts (TDAs), *i.e.*, balance due assessments, as residing in the Collection queue. IRS, Collection Activity Report NO-5000-2, *Taxpayer Delinquent Account Cumulative Report*, (Oct. 4, 2009).

11 National Taxpayer Advocate 2008 Annual Report to Congress 26-28; National Taxpayer Advocate 2007 Annual Report to Congress 374-87; National Taxpayer Advocate 2006 Annual Report to Congress 83-109, 507-19; National Taxpayer Advocate 2005 Annual Report to Congress 270-91; National Taxpayer Advocate 2004 Annual Report to Congress 226-45, 311-41, 433-50; National Taxpayer Advocate 2003 Annual Report to Congress 99-112; National Taxpayer Advocate 2002 Annual Report to Congress 15-24; National Taxpayer Advocate 2001 Annual Report to Congress 202-15.

12 The MITRE Corporation, *Statement of Work, Federally Funded Research and Development Center, Offer in Compromise: Study in the Qualified OIC Application* (Mar. 31, 2009); Porter Novelli Public Strategies, *Statement of Work, Commissioner's Taxpayer Communications Taskgroup (TACT), Communications Simplification Program—Offers in Compromise Program* (Apr. 2009).

to abide by the tax laws for at least five years.[13] The IRS's offer program allows for the compromise of tax liabilities based upon:[14]

- Doubt as to liability (DATL) – a legitimate doubt exists that the taxpayer owes part or all of the assessed tax liability;
- Doubt as to collectibility (DATC) – doubt exists that the taxpayer could pay the full amount of the liability within the remaining statutory period for collection; or
- Effective Tax Administration (ETA) – the taxpayer does not have any doubt that the tax is correct and there is potential to collect the full amount, but "economic hardship" or "equity and/or public policy" conditions are present.[15]

Most OIC applications fall into the DATC category. IRS procedures allow for the acceptance of a DATC offer when the amount offered reflects reasonable collection potential (RCP), unless special circumstances exist.[16] The IRS calculates RCP as an amount equal to the fair market value of all of the taxpayer's equity in his or her assets, plus four, five, or more years' worth of future income (net of reasonable living expenses).[17]

IRS policy accurately reflects Congress' intent for the OIC program.

In 1992, the IRS adopted Policy Statement P-5-100 concerning the use of the OIC in IRS collection cases, which states:

> The IRS will accept a DATC offer when the IRS is unlikely to collect the tax liability in full and the taxpayer's offer reasonably reflects collection potential. An OIC is a legitimate alternative to the IRS declaring a case currently not collectible or to a protracted installment agreement. The IRS's goal is to achieve collection of what is potentially collectible at the earliest possible time and at the least cost to the government, and to reach a compromise which is in the best interest of both the taxpayer and the IRS. Where an OIC appears to be a viable solution, the IRS employee assigned the case will discuss an OIC with the taxpayer and, when necessary, assist in preparing the required forms. The taxpayer is expected to initiate the first specific proposal for compromise, and provide reasonable documentation to verify his or her ability to pay. The success of the compromise program will be assured only if taxpayers make adequate compromise proposals consistent with their ability to pay and the IRS makes prompt and reasonable decisions. Acceptance of an adequate OIC will also result in creating for the taxpayer an

13 Internal Revenue Code (IRC) § 7122.

14 IRC § 7122; Treas. Reg. § 301.7122-1, *et seq.*; Form 656, *Offer in Compromise* (Mar. 2009); Form 656-B, *Offer in Compromise Booklet* (Mar. 2009).

15 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.

16 IRM 5.8.1.1.3(3) (Sept. 23, 2008) and IRM 5.8.4.4 (Sept. 23, 2008). The IRS can accept a DATC offer if special circumstances exist that create an economic hardship and prevent a taxpayer from being able to pay the reasonable collection potential (RCP).

17 IRM 5.8.1.1.3(1) (Sept. 30, 2008).

> expectation of and a fresh start toward compliance with all future filing and payment requirements.[18]

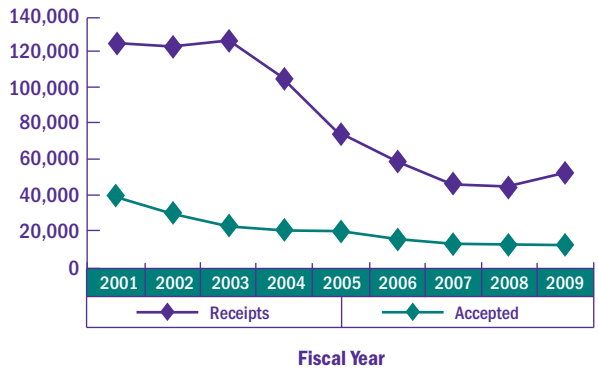
Congress elevated this policy and explicitly supported OICs as a viable collection alternative, in the conference committee report for the IRS Restructuring and Reform Act of 1998 (RRA 98), as evidenced by the following statement:

> The conferees believe that the IRS should be flexible in finding ways to work with taxpayers who are sincerely trying to meet their obligations and remain in the tax system. Accordingly, the conferees believe that the IRS should make it easier for taxpayers to enter into offer in compromise agreements, and should do more to educate the taxpaying public about the availability of such agreements.[19]

The Current State of the OIC Program

As illustrated by Figure 1.14.1 below, the IRS OIC program has experienced a steady decline over the past nine years.[20]

FIGURE 1.14.1, FY 2001 – FY 2009 OIC Receipts and Acceptances



Although the declining use of OICs cannot be blamed on one event, it can be traced to several contributing factors, including:

- A daunting application process;
- The "bottleneck" of centralization;

18 IRM 1.2.14.1.17 (Jan. 30, 1992).

19 H.R. Rep. No. 105-599, at 289 (1998) (Conf. Rep.).

20 IRS, Collection Activity Report NO-5000-108, *Monthly Report of Offer in Compromise Activity (FY 2001-FY 2008)*; IRS, Collection Activity Report NO-5000-108, *Monthly Report of Offer in Compromise Activity* (Sept. 30, 2009).

- Internal perceptions and attitudes that show little support for OIC acceptances;
- New rules and legislation that have made it more difficult and expensive for taxpayers to submit an OIC; and
- The public's perception that OICs are not viewed as a viable collection alternative.

The OIC application process is too daunting for many taxpayers.

As part of the offer process, the IRS requires that taxpayers fully document all financial information included on Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals* (and Form 433-B, *Collection Information Statement for Businesses*, should a taxpayer have business activities or interests). One of the more stringent requirements is for taxpayers to submit at least three (and in some cases up to 12) months of bank statements, regardless of the taxpayers' financial situations.[21] Moreover, taxpayers are also asked to furnish copies of several months of mortgage and car loan statements, insurance premiums, and utility bills along with their OIC applications. Individuals with financial difficulties may not be able to gather this information, *e.g.*, they may have transient living arrangements, may have to pay large fees, or are unbanked. Yet, if a taxpayer fails to submit all "required" financial documentation, the IRS may arbitrarily return the taxpayer's OIC, keep any funds originally or subsequently paid with the offer, and afford no appeal rights for review of the IRS's determination.[22]

Today, a taxpayer must complete more than 100 steps, of which half involve transferring information from the Form 433-A or B to a worksheet in the package, to apply for an OIC.[23] In 1997, a Form 656, *Offer in Compromise*, plus the required collection information statement, totaled 16 pages.[24] In March 2009, the IRS issued revised forms for offer submissions,[25] and claims that its new Form 656 is "slimmed down."[26] However, the revisions actually added two pages to the 44 pages of the total OIC package already in use. Moreover, there was no substantive change to the Form 656. The forms and instructions create confusion for most taxpayers and further erode the opportunities for the IRS to receive acceptable OICs.

21 IRM 5.8.5.3.2(7) (Sept. 23, 2008).

22 IRM 5.8.7.2.2 (Sept. 23, 2008).

23 Siegel & Gale, *Offer In Compromise, Strategic Recommendations* 10-13 (July 31, 2009).

24 *See* IRS, Form 656 (rev. Jan. 1997), and Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals* (rev. Sept. 1995) or Form 433-B, *Collection Information Statement for Businesses* (rev. June 1991).

25 IRS, Form 656 (rev. Mar. 2009) and Form 656-B (rev. Mar. 2009).

26 *See IRS Issues New Form 656 Booklet and Revised Offer in Compromise Form*, at http://www.irs.gov/businesses/small/article/0,,id=210594,00.html (last viewed Oct. 16, 2009).

OIC centralization has created a "bottleneck."

In August 2001, faced with an increasing number of offers and processing delays, the IRS implemented its Centralized Offer in Compromise (COIC) operation.[27] The COIC shifted responsibility for OIC processing from Collection Field function (CFf) personnel to two IRS campuses (Brookhaven, New York and Memphis, Tennessee). The IRS also instituted more rigorous requirements for processing OICs out of concern that it was receiving too many frivolous ones.

Through centralization, the IRS placed more emphasis on "moving" the workload, rather than employees resolving collection cases with OICs. As shown in Figure 1.14.1, offer acceptances have declined each year since the inception of COIC, particularly from FY 2001 to FY 2002 (the first full year of COIC) when acceptances declined by 24.6 percent.[28] The impact of centralization has been a "bottleneck" for processing a growing number of seemingly acceptable cases with a limited number of employees.

Internal perceptions and attitudes show little support for OIC acceptances.

In February 2009, the IRS issued interim guidance to relax the processability determination for low income taxpayers and conduct a "second level" review of OICs rejected due to real property valuations.[29] In spite of the revised guidance, the IRS still does not have a "new" approach to working with taxpayers and accepting good offers. A case in point appears to be the "second level" review process. Given the nation's current economic flux and feeble real estate market, this process seems like a prudent business decision. However, the "second level" unit has only reviewed a total of seven offers, accepting just one.[30]

Current OIC procedures foster rejection and do not afford one-stop customer service.

Internal Revenue Manual (IRM) guidance establishes a distinctly flat tone regarding OIC acceptance. The IRS appears to use a narrow approach toward the analysis and investigation of a taxpayer's offer. Consider, for example, the "screen for obvious full pay" procedures used by the COIC operations. In these situations, offer examiners determine through a cursory review the taxpayer's collection information statement and determine that the taxes can be full paid, either immediately or through an installment agreement (IA), and the IRS rejects the taxpayer's offer without any discussion or negotiation with the taxpayer.[31]

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27 *See* Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2003-30-182, *Continued Progress is Needed to Improve the Centralized Offer in Compromise Program*, 1-3 (Sept. 2003). General Accounting Office (GAO), GAO-02-311, *IRS Should Evaluate the Changes to its Offer in Compromise Program* (Mar. 15, 2002).

28 IRS, Collection Activity Report NO-5000-108, *Monthly Report of Offer in Compromise Activity (FY 2001-FY 2008)*.

29 SB/SE, *Interim Guidance for Low Income Processability Procedures* (Feb. 2, 2009); SB/SE, *Interim Guidance for Additional Review of Real Property Valuations in Offer in Compromise Cases* (Feb. 2, 2009).

30 SB/SE response to TAS research request (July 20, 2009). Of the seven OICs, one was accepted for an amount equal to the RCP, three were rejected because the taxpayer could pay more than the offer amount, and the remaining three were pending further investigation.

31 IRM 5.8.3.12 (Sept. 23, 2008).

According to IRS policy, an OIC is considered a suitable alternative to a protracted IA or reporting an account CNC. When an OIC is recommended for return or rejection and an IA or CNC is appropriate, an OIC examiner or specialist is responsible for initiating any such action.[32] This direction has been in place since 2001 but the OIC functions cannot effect these actions on the Automated Offer in Compromise (AOIC) system.[33] Moreover, the IRS has no internal controls in place to track or confirm that these actions are taken. The IRS's "default" position on these accounts is to return them to the general collection stream despite having complete financial information to resolve them.[34] Thus, a taxpayer willing to enter into an IA or deemed unable to pay could end up with an unnecessary enforcement action, such as a levy or lien. By failing to resolve all of the taxpayer's collection issues during the OIC investigation, the IRS is missing a golden opportunity to provide the one-stop service it has recently adopted in its FY 2009-2013 Strategic Plan.[35]

A lack of adequate OIC resources, training, and geographical presence sends the wrong message to employees and taxpayers.

The IRS's OIC staffing plans add fuel to the perception of a lack of support for the OIC program. The IRS employs 390 workers to operate its two COIC sites and 174 workers in its CFf to handle OIC investigations that COIC cannot work.[36] In FY 2009, the IRS devoted nearly 55 percent fewer Collection staff hours to the OIC program than it invested in the program in FY 2001.[37] Moreover OIC hours represented only 2.7 percent of the total Collection direct hours reported for FY 2009.[38]

While "centralization" of the processing of OICs may allow the IRS to cut staffing, it also creates problems when the IRS tries to communicate and work with taxpayers who submit offers. Additionally, the IRS does not maintain any local presence for its OIC investigations. Field-based OIC work is currently performed by offer specialists in Alabama, Arkansas, California, Florida, Georgia, Louisiana, Mississippi, Oklahoma, Tennessee, and Texas, leaving a void of local or regional knowledge in many heavily populated or economically distressed areas, such as New York, Illinois, Pennsylvania, or Michigan. Moreover, the IRS has earmarked funds to hire 1,000 new collection employees out of the additional

32 SB/SE, *Interim Guidance for Reissuance of Updated Procedure to Refer Closed Rejected, Return and Withdrawn Offer Cases for Next Appropriate Action*, SBSE-05-0909-055 (Sept. 29, 2009).

33 The Automated Offer in Compromise (AOIC) system is the primary database for all OIC activities, but does not interface with the IRS's Integrated Data Retrieval System (IDRS) where all master file data for individual and business taxpayers is maintained.

34 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. 2004).

35 IRS Pub. 3744, *IRS Strategic Plan 2009-2013* (Apr. 2009) at http://www.irs.gov/pub/irs-pdf/p3744.pdf (last viewed Sept. 28, 2009).

36 SB/SE response to TAS research request (July 20, 2009).

37 IRS, Collection Activity Report NO-5000-C23, *Collection Workload Indicators Reports* (FY 2001 and FY 2009); SB/SE response to TAS research request (Oct. 29, 2009).

38 *Id.*

$400 million budgeted for enforcement activities in FY 2010, yet none of these funds appear to benefit or enhance the OIC program.[39]

With little guidance outside of the Collection IRM 5.8 or OIC occupations, the IRS sends the message that only certain employees should consider the OIC as a viable collection tool. Before August 2008, most assistors in the Automated Collection System (ACS) or Accounts Management (AM) were not trained about OICs. While current training instructs assistors to inform taxpayers of OICs, it does not instruct them to assist taxpayers as envisioned in the policy statement.[40]

New rules and additional legislation have made it more difficult and expensive for taxpayers to submit an OIC.

Since November 1, 2003, the IRS has required taxpayers submitting offers, except DATL offers, to include a $150 user fee (or a fee waiver for low income taxpayers).[41] The IRS intended that the fee would reimburse part of the OIC program expenses and reduce frivolous or unreasonable OIC submissions.[42] Subsequent to imposition of the fee, OIC submissions declined by 28 percent.[43]

The Tax Increase and Prevention Reconciliation Act of 2005 (TIPRA) has further discouraged taxpayers from submitting OICs.[44] Under TIPRA, taxpayers must generally provide down payments when applying for OICs. The IRS waives this requirement for taxpayers whose incomes do not exceed 250 percent of the poverty level.[45] In the case of a lump sum OIC (paid in five or fewer installments), the down payment is 20 percent of the offered amount. In the case of a "periodic payment" OIC, the taxpayer must make an installment payment with the OIC application, and continue to make the proposed installment payments during the pendency of the OIC. Congress may repeal the TIPRA payment provisions as recommended by the National Taxpayer Advocate and proposed as part of the 2010 White House budget to help struggling taxpayers into OICs.[46] If enacted, taxpayers would

39 *See House Passes IRS Funding Boost in Financial Services Appropriations Bill*, Tax Notes Today, July 17, 2009). H.R. 3170 passed the House was received in the Senate on July 20, 2009. It has been read twice and placed on Senate Legislative Calendar under General Orders. Calendar No. 115.

40 While ACS and AM IRMs (IRM 5.19 and IRM 21) do contain general descriptions of OICs, the IRS has given little or no guidance to employees answering taxpayers' questions about OICs.

41 T.D. 9086, 68 Fed. Reg. 48,785 (Aug. 15, 2003); Treas. Reg. § 300.3.; Rev. Proc. 2003-71, 2003-36 I.R.B. 517 § 5.01. In order to be exempted from the OIC application fee, a taxpayer must file Form 656-A, *Income Certification for Offer in Compromise Application Fee (For Individual Taxpayer Only)* when submitting their OIC. Taxpayers whose income is 250 percent below the poverty guidelines issued annually by the Department of Health and Human Services are deemed to be low income for purposes of the OIC application fee waiver.

42 T.D. 9086, 68 Fed. Reg. 48,785, 48,786 (Aug. 15, 2003) (preamble).

43 *See* TIGTA, 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).

44 Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), Pub. L. No. 109-222, § 509, 120 Stat.345, 362 (2006).

45 *See* IRS Fact Sheet, 2007-16, *Revisions to Form 656, Offer in Compromise, available at* http://www.irs.gov/newsroom/article/0,,id=168404,00.html (last visited Oct. 16, 2009). For this purpose, the poverty guidelines issued annually by the Department of Health and Human Services are used.

46 Tax Compromise Improvement Act of 2009, H.R. 2343, 111th Cong. § 2 (May 12, 2009). Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals* at 99 (May 2009). *Tax Compliance Challenges Facing Financially Struggling Taxpayers: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 111th Cong. (Feb. 26, 2009) (statement of Nina E. Olson, National Taxpayer Advocate).

not be required to submit a partial payment with their OIC applications. The National Taxpayer Advocate believes that the repeal of TIPRA would draw more receipts to the OIC program, but remains concerned that the IRS may not accept more offers.

The public's perception and attitude reveal OICs are not viewed as a viable collection option.

The 2006 IRS Customer Satisfaction Survey revealed that taxpayer's believe the "IRS is predisposed to rejecting offers and that the IRS is not realistic in considering taxpayer circumstances."[47] The survey noted "improvements may be needed in IRS flexibility, time required, and communication of all forms." These results mirror comments the National Taxpayer Advocate hears at town hall and practitioner meetings.

The Ideal State of the OIC Program

The IRS does not need to reinvent the wheel to maximize OIC effectiveness. In many respects, all it needs to do is look back and reinstate its prior procedures, which more closely mirror both its OIC policy and Congress's intent.

Reinstate the 1992 IRM provisions.

In 1992, when the IRS implemented Policy Statement P-5-100, it also instituted procedural guidance to foster an environment that supported the use of the OIC as an important tool for Collection employees in resolving tax delinquency cases. The following IRM sections were included in the 1992 policy changes:

> Rejection of an offer solely based on narrow asset and income evaluations should be avoided. The Service should attempt to *negotiate* (emphasis added) offer agreements, which are in the best interests of all parties. Included in determining the government's interests are the costs of collection. If an offer is rejected because more can be collected than is offered, *it is generally expected that the amount determined to be collectible will actually be collected* (emphasis added).[48]
>
> When criminal proceedings are not contemplated and an analysis of the taxpayer's assets, liabilities, income and expenses show that a tax liability cannot be realistically collected in full, the possibility of an offer in compromise *will be discussed* (emphasis added) with the taxpayer.[49]
>
> . . . [S]ince valuations of property . . . are not scientifically exact, care should be exercised to avoid inflexible, non-negotiable values.[50]

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47 IRS, SB/SE Research, *Offer in Compromise (OIC) Customer Satisfaction Survey Research Report – Project FTL0023* (Aug. 2006). The IRS initiated another customer satisfaction survey in late 2008 but as of this date, the findings are unavailable.

48 IRM 57(10)(10).1 (Feb. 26, 1992).

49 IRM 57(10)5.1 (Feb. 26, 1992).

50 IRM 57(10)(10).1(2) (Feb. 26, 1992).

> The Service needs to take into consideration the increasing cost of living as a factor in determining amounts potentially collectible from future income.[51]
>
> . . . [O]ffer examiners should remain flexible toward negotiating an offer that, considering all factors, would be in the government's best interests.[52]

Although this direction seems to reflect the intent and spirit of the IRS policy regarding OICs, the IRS eliminated these procedures in the mid-90s. In spite of Congress's support for OICs articulated in RRA 98, the IRS did not reinstate them after RRA 98 became law.

The IRS misses many opportunities to use the offer program to not only recover aging, delinquent revenue, but also to provide a "fresh start" for taxpayers. The IRS's studies have shown that OICs generally yield a higher rate of return (from 18 to 20 cents for every dollar owed)[53] than other Collection enforcement methods (historically 13 cents for every dollar collected on debts over two years old and virtually nothing on debts outstanding for three years or more).[54] IRS data reveal that, as of March 2009, approximately 75 percent of "active" collection accounts involve tax periods that are more than three years old.[55] Accordingly, the IRS should consider the collectibility curve and explore OICs in cases where *any* part of the liability has aged more than three years.[56]

Accepting offers also encourages voluntary compliance. The IRS determined that "approximately 80 percent" of taxpayers whose OICs were accepted between 1995 and 2001 remained in compliance with their subsequent filing and paying requirements.[57] TIGTA reported in a similar study that 96 percent of taxpayers who had accepted OICs were in compliance.[58]

Return OICs to the revenue officer's toolbox and promote one-stop service for taxpayers whose offers are rejected.

Any Collection employee who reviews a taxpayer's detailed financial information and considers a collection action or alternative, *e.g.,* lien, levy, seizure, IA, CNC, should be empowered to recommend the acceptance of an OIC. This approach would provide "one-stop" service for taxpayers seeking resolution of their tax debts. Moreover, any Collection

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51 IRM 57(10)(10).1(3) (Feb. 26, 1992).

52 IRM 57(10)(10).2(1) (Feb. 26, 1992).

53 In FY 2008, accepted offers generated 20 cents for every dollar collected. IRS, Collection Activity Report NO-5000-108 (Sept. 30, 2008). In FY 2009, accepted offers generated 18 cents for every dollar collected. IRS, *Offer in Compromise Program, Executive Summary* (Sept. 30 2009).

54 IRS/Booz-Allen & Hamilton, *SB/SE Collections Quick Hits Approach and Preliminary Findings* 30 (Mar. 27, 2001); IRS, Automated Collection System Operating Model Team, Collectibility Curve (Aug. 5, 2002).

55 IRS, Collection Activity Report NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Mar. 2009).

56 The collectibility curve is a commonly recognized business concept that holds that delinquent accounts receivables become less collectible as they age.

57 SB/SE, *Offers in Compromise Program: Analysis of Various Aspects of the OIC Program* 6 (Sept. 2004).

58 TIGTA, Ref. No. 2009-30-018, *Despite the Success Achieved, the Son of Boss Settlement Had Little Impact on Investor Filing and Payment* (Dec. 30, 2008).

employee rejecting a taxpayer's OIC should initiate other collection alternatives to resolve the taxpayer's case.

Streamline OIC forms or processes

The IRS needs to streamline the OIC application process. Generally, the request for consideration of an offer should require no more documentation than a routine home loan. The financial information needed to make an acceptance determination for most OICs can generally be verified through IRS sources eliminating the need for extensive supporting documentation from taxpayers. This concept is not new. The IRS implemented "streamlined investigations" for OICs in November 2000 to reduce backlogged OIC inventories.[59] However, the IRS abandoned this procedure when OIC inventories started to decline. TAS is unaware of any negative consequences from these procedures. The basic concept, *i.e.*, reducing the burden on taxpayers and costs associated with working OICs, makes good business sense today.

IRS determinations of reasonable collection potential should reflect acceptable offer amounts that are reasonable, realistic, and attainable.

The IRS has a poor track record at collecting accounts where OICs have been rejected or returned.[60] Yet, RCP calculations in OIC cases seem designed to reject offers. OIC rejections based on narrow asset and income evaluations seem to be a requirement for today's offer investigations. For example, consider the IRS's valuation of dissipated assets – assets that are transferred, gifted, sold, or used for unnecessary expenses or other debts.[61] Collection's approach is to include a dissipated asset in RCP and ask questions later. This approach appears to be punitive, given that the assets are gone and the taxpayer has no legal claim to them. If the IRS believes assets were deliberately dissipated in anticipation of an OIC submission, it should allow the taxpayer to demonstrate that he or she is acting in good faith or that there were extenuating circumstances with respect to the transfer rather than rejecting the OIC under current procedures.

The OIC determination process requires a conversation with the taxpayer.

For the OIC program to operate as intended, timely and meaningful dialogue is essential. Moreover, the IRS should decrease or even eliminate the information required at the initial stage. The taxpayer would submit the completed forms for the offer processor to review and supplement with information already available, *e.g.*, income and real property information, and then the IRS would assign the offer to an Offer Examiner (OE) or Offer Specialist (OS). The OE or OS would schedule a conference and discuss the process, *i.e.*, information needed or an acceptable offer amount, with the taxpayer. The OE or OS would confirm this discussion with correspondence containing a checklist of information needed and a

59 IRM 5.8.4.14 (Nov. 1, 2000).

60 *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).

61 IRM 5.8.5.5 (Sept. 23, 2008).

preliminary RCP computation. The forms should merely start the conversation with the taxpayer; it is incumbent upon the OE or OS to discuss the "full story" of the taxpayer's ability to pay the tax debt. This is especially true in situations involving special circumstances, and ETA (hardship and non-hardship) offers. The IRS should not reject or return an OIC without providing the taxpayer an opportunity to tell his or her side of the story.

Enforcement of Circular 230 against preparers of OICs.

Many taxpayers tell the National Taxpayer Advocate that operators of "offer mills" charge them large upfront fees for preparation of OICs, but fail to follow up when the IRS requests additional information. This leads to rejection of their offers. The IRS finds it difficult to track preparers of OICs and the related financial information statements. There is no legal requirement for the preparer to sign Forms 656, 433-A, 433-B, or 433-F.[62]

On April 6, 2009, the IRS's Office of Professional Responsibility (OPR) suspended an enrolled agent for not performing services related to OICs paid for by taxpayers.[63] A Circular 230 practitioner (an attorney, certified public accountant, enrolled agent, or actuary) must exercise due diligence and promptly resolve matters in representing taxpayers before the IRS and must not make misleading or deceptive claims in advertising to taxpayers.[64] However, OPR does not have the ability to suspend a preparer who does not provide preparer information on Form 656, and does not have the authority to regulate unenrolled or unlicensed agents. Further, the IRC § 6695 penalty for failure to sign returns or claim refunds does not apply to these documents.[65] The National Taxpayer Advocate believes that requiring preparers to sign OICs prepared by them, subject to IRC § 6695 penalties, will provide the IRS with a valuable tool to identify unskilled and unscrupulous preparers.

CONCLUSION

The OIC program is failing to serve taxpayers, despite IRS efforts. Congress intended with the passage of RRA 98 that the IRS should pursue OICs as a collection alternative. The IRS can achieve a "win-win" with the OIC program. The IRS wins by receiving a sum of money that it could not have collected and attains voluntary taxpayer compliance (at least for the next five years). The taxpayer wins by obtaining a fresh start. Through flexibility and fairness in its administration of the OIC program, the IRS can meet its goal of collecting what is potentially collectible at the earliest possible time and at the least cost to the government. And when it does, everyone benefits.

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62 IRS, Form 656, *Offer in Compromise*, 4 (rev. Mar. 2009). The Privacy Act Statement states that providing the paid preparer's name and identifying information is voluntary and may be used to regulate practice before the IRS under Circular 230 if the preparer is a Circular 230 practitioner.

63 IRS News Release, IR-2009-35, IRS Suspends Tax Practitioner for Failing to Provide Service Related to Offers in Compromise (Apr. 7, 2009) (on file with author).

64 Treasury Department Circular No. 230 §§ 10.22, 10.23 & 10.30 (Apr. 2008).

65 *See* National Taxpayer Advocate 2003 Annual Report to Congress 285.

For the IRS to restore credibility and viability to its OIC program, the National Taxpayer Advocate offers these preliminary recommendations:

1. Reinstate its 1992 procedures to more closely follow Policy Statement P-5-100;
2. Recommend OICs consistent with the collectibility curve to taxpayers whose tax liabilities have aged more than three years;
3. Place the ability to work and accept OICs back in the revenue officer's collection toolkit and provide one-stop service for taxpayers whose offers are rejected, *e.g.*, have revenue officers or other employees grant IAs or report accounts CNC after OIC rejection;
4. Revise Form 656 to eliminate substantiation and large amounts of documentation upon submission and create procedures so that Form 656 starts the conversation with taxpayers;
5. Change its procedures to require that offer processors build an offer file with information the IRS already has, and that offer examiners or offer specialists will explore the possibility of the offer with taxpayers, *e.g.*, RCP, special circumstances, etc., gather additional information, and follow-up with correspondence;
6. Develop RCP guidelines to allow more flexibility and eliminate dissipated assets procedures; and
7. Revise Forms 433 and 656 to require that all paid preparers sign the forms.

IRS COMMENTS

The Offer in Compromise program is an important alternative for taxpayers that are not able to pay in full, especially those taxpayers that are experiencing economic difficulty. Like the National Taxpayer Advocate, the IRS recognizes there are opportunities to maximize OIC effectiveness and will continue to take steps to improve the program and its availability to taxpayers that qualify. Our goals for the OIC program include ensuring that OICs are available and accessible to all taxpayers that qualify, to make timely decisions on cases, and to accept offers that are appropriate and consistent with taxpayers' circumstances and ability to pay.

As part of our continuing efforts to improve the OIC program, the IRS engaged external stakeholders. In June 2008, the IRS contracted with Siegel & Gale to conduct a review of the Form 656-B, *Offer in Compromise Booklet*, and to provide suggestions on how to simplify the booklet and the Form 656. At the same time, we engaged the MITRE Corporation to look into declining OIC receipts. The goal of MITRE's study is to determine the causes for the decline in qualified OIC requests and to identify improvement opportunities. The results and recommendations are being reported to an OIC Executive Advisory Board and will be used to continue to further improve and simplify the program.

In addition, the IRS implemented several changes to the offer program in February 2009 aimed at assisting taxpayers experiencing economic difficulties. The changes included:

- Fully investigating OICs submitted by qualifying low income taxpayers even without the upfront required forms and/or payments;[66]
- Providing an additional review of offers to confirm the value of real property and ensure that the reasonable collection potential is properly determined;[67] and
- Revising procedures for determining when an OIC was in default and providing more flexibility to revise the terms of the accepted offers.[68]

The IRS believes improvements should be geared toward ensuring that taxpayers who qualify have knowledge of and access to the program, as well as maximizing the number of cases in which the IRS is able to complete the investigation timely and make an appropriate decision to accept or reject the offer.

While it is true that the number of OICs in recent years has declined, the IRS has experienced an 18.4 percent increase in receipts for fiscal year FY 2009 over the same period in FY 2008.[69] As a result of changes made to our policies and procedures, the percentage of cases closed in less than nine months has continuously improved from 89 percent in FY 2007, to 91 percent in FY 2008, and 94 percent in FY 2009.[70] While we work to improve the timeliness of OIC processing, we are concurrently focused on improving the quality of our cases. As a result, the embedded quality score (the score assigned through evaluative reviews) has shown substantial and consistent increases since FY 2006. In FY 2009 the embedded quality score increased to 87 percent from 76.4 percent in FY 2006.[71] In Centralized Offer in Compromise (COIC), embedded quality scores were implemented in FY 2004 and have remained consistently high. For example, in FY 2009 the COIC embedded quality scores for customer accuracy, timeliness, and professionalism were 96.56 percent, 99.86 percent, and 98.07 percent, respectively.[72]

The IRS has taken several steps to reduce the number of OIC cases that are returned to the taxpayer without full investigation by IRS personnel. Since FY 2006, there are only three reasons an offer may be returned immediately without any further processing; failure to include the application fee, failure to include the required payment, or taxpayer is in bankruptcy. As a result of these changes, only 11 percent of the cases were immediately returned in FY 2009, compared to 31 percent in FY 2004.[73] We also made changes to our procedures for cases in which we have incomplete information from the taxpayer. These

66 SB/SE, *Interim Guidance for Low Income Processability Procedures* (Feb. 2, 2009).

67 SB/SE, *Interim Guidance for Additional Review of Real Property Valuations in Offer in Compromise Cases*, (Feb. 2, 2009).

68 SB/SE, *Interim Guidance for Offer to Compromise an Accepted Offer* (Feb. 2, 2009).

69 IRS, Collection Activity Report NO-5000-108, *Monthly Report of Offer in Compromise Activity* (Sept. 30, 2009). IRS, Collection Activity Report NO-5000-108, *Monthly Report of Offer in Compromise Activity* (FY 2001-FY 2008).

70 IRS, Collection Activity Report NO-5000-108, *Monthly Report of Offer in Compromise Activity* (FY 2007- FY 2009)

71 IRS, *National Quality Review System Data, Field OIC FY 2007 and FY 2009*.

72 IRS, *National Quality Review System Data, COIC FY 2009.*

73 IRS, Collection Activity Report NO-5000-108, *Monthly Report of Offer in Compromise Activity* (FY 2004 and FY 2009).

revisions have significantly contributed to a steady decline (36 percent in FY 2003 to 16 percent in FY 2009) of offers being returned, as a percentage of total dispositions.[74]

The IRS agrees with the National Taxpayer Advocate that the decline in OIC receipts cannot be blamed on any one event but rather several contributing factors. Two of the significant factors are the implementation of the $150 application fee and the down payment requirement included in the Tax Increase and Prevention Reconciliation Act of 2005. Congressional bill H. R. 2343, "Tax Compromise Improvement Act of 2009," was introduced to repeal the down payment requirement as a means of increasing participation in the program. If implemented, we believe this change, when coupled with our ongoing improvement efforts, will result in the offer program attracting more taxpayers for whom an OIC is the appropriate resolution of their tax liability.

The IRS agrees that the application process requires a substantial amount of supporting documentation. The key is to find a balance between the information needed to make a decision and taxpayer burden. The IRS is committed to requesting only the information or documentation necessary to properly evaluate a taxpayer's offer and for the IRS to make an informed decision. In a 2006 report, TIGTA noted that while providing the documentation "... [M]ay seem burdensome to taxpayers, it is necessary for the IRS to reach the proper decision to accept or reject the offer." In the same report, TIGTA stated, "... [I]t is crucial that the processing requirement be clearly stated so taxpayers can evaluate their situations prior to filing an offer."[75] The IRS will take into consideration recommendations made to the OIC Executive Advisory Board (which includes the National Taxpayer Advocate) by Siegel & Gale, and the MITRE Corporation, for improving the Form 656-B, *Offer in Compromise Booklet*, and the Form 656, including required documentation.

We do not believe the COIC has contributed to the decline in receipts. Rather, COIC provided improved customer service by eliminating large backlogs of OIC work and improved the timeliness of case processing. In FY 2001, 25 percent of the cases took over 12 months to resolve and in FY 2009 this figure was down to four percent.[76] As previously noted, the percentage of cases closed in less than nine months has continuously improved to a rate of 94 percent in FY 2009.[77]

The IRS, like the National Taxpayer Advocate, believes that taxpayers should be afforded one-stop customer service. In 2007, we issued Interim Guidance Memorandum SBSE-05-0909-055 which states in part, "In instances where a taxpayer's offer in compromise (OIC) has been investigated and a decision was made to not accept the offer, it is important to continue toward a resolution and utilize the financial information received

74 IRS, Collection Activity Report NO-5000-108, *Monthly Report of Offer in Compromise Activity* (FY 2003- FY 2009).

75 *See* TIGTA, Ref No. 2006-30-100, *The Offer in Compromise Program is Beneficial but Needs to Be Used More Efficiently in the Collection of Taxes* (July 17, 2006).

76 IRS, Collection Activity Report NO-5000-108, *Monthly Report of Offer in Compromise Activity* (FY 2001 and FY 2009).

77 IRS, Collection Activity Report NO-5000-108, *Monthly Report of Offer in Compromise Activity* (FY 2009).

and verified during the offer process." We will continue to emphasize these procedures to ensure that the appropriate resolution is identified prior to closing the case, when a taxpayer's offer is not accepted.

The IRS is committed to devoting the necessary amount of resources to ensure OICs are processed efficiently. Reduced offer receipts naturally correspond to reduced staffing; however, not at the rate cited by the National Taxpayer Advocate. In addition, the IRS continuously reviews the OIC staffing to ensure that appropriate resources are available.

The IRS ensures that non-OIC personnel are adequately trained to assist taxpayers regarding collection alternatives, including OICs. Specifically, the Automated Collection System has a robust training program that instructs employees on how to assist taxpayers who are unable to full pay their tax debt. Training materials focus on equipping the employees with the necessary skills and tools to determine the most viable payment option based on a taxpayer's current financial situation. The ACS Basic Training course provides an overview of the OIC program and instructs new employees on how and when to communicate the OIC option to the taxpayer. Employees can also access the OIC checklist in Accounts Management Services (AMS) to guide them through the actions to take if a taxpayer has already filed or plans to file an OIC.

The National Taxpayer Advocate makes seven preliminary recommendations to restore credibility and viability to the OIC program. The IRS is taking or has taken the following actions with respect to these recommendations:

We believe current procedures outlined in IRM 5.8, *Offer in Compromise*, and interim guidance fully support Policy Statement P-5-100, and reverting back to 1992 policies and procedures would not benefit taxpayers or the IRS.

Our procedures ensure that we make acceptance determinations consistent with the taxpayer's ability to pay regardless of age of the case. The formula that is used to compute the reasonable collection potential considers what can be collected from the taxpayer in the future.

Revenue officers play an important role in identifying collection alternatives for taxpayers in their inventory and, as such, they need to identify cases where an offer may be the appropriate resolution. When a revenue officer receives an offer on a case assigned to him or her, the revenue officer is required to make a recommendation on the offer based on his or her investigation and knowledge of the case. We do not believe it is an efficient use of resources to make all revenue officers into offer specialists. In 2007, we issued Interim Guidance Memorandum SBSE-05-0909-055 which states, "In instances where a taxpayer's offer in compromise (OIC) has been investigated and a decision was made to not accept the offer, it is important to continue toward a resolution and utilize the financial information received and verified during the offer process." These procedures ensure that in cases

where a taxpayer's offer is not accepted appropriate resolution will be taken prior to closing the case.

The IRS has initiated several projects that will provide feedback on the Form 656 and the application process. We will consider the feedback provided by these external sources, as well as the National Taxpayer Advocate's recommendations in the development of any changes to the application process.

Current procedures direct offer personnel to verify as much of the collection information statement (CIS) as possible through internal sources. In addition, guidance is provided to offer examiners and specialists for communicating with taxpayers regarding the reasonable collection potential (RCP) and addressing special circumstances.

We believe current procedures allow offer examiners and specialists to be flexible and deviate from RCP guidelines when appropriate. IRM 5.8.5.5 states that dissipated assets should not be automatically included in the RCP, and each case must be evaluated on its own merit. We are in the process of revising the IRM and will consider the National Taxpayer Advocate's recommendation when drafting new guidance on dissipated assets.

The IRS has previously responded to the National Taxpayer Advocate concerning the requirement that all paid preparers sign the Forms 433A and 656. This cannot be implemented without legislative change. The IRS does not deem the preparation of the Form 656 as practice before the Internal Revenue Service. If a Form 656 is prepared by a practitioner covered by Circular 230, the provisions of Circular 230 will apply. Unenrolled return preparers who prepare Form 656 are not entitled to represent taxpayers in the offer in compromise process.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS acknowledges the significance of OICs for taxpayers who are unable to pay their tax liabilities. We also recognize and commend the IRS's efforts to improve the OIC program through its engagement of Siegel & Gale and the MITRE Corporation to review the forms and investigate declining receipts. However, the National Taxpayer Advocate is concerned that the IRS continues to minimize the significance of the OIC program's decline, ignores its customer satisfaction ratings, and fails to acknowledge the program's importance to the IRS's overall collection strategy.

The National Taxpayer Advocate believes the IRS's new procedures do not adequately address the underlying issues that precipitated these changes. The IRS response highlights three procedural changes implemented in FY 2009. While we agree that these are steps in the right direction, these changes have shown little impact in practice. For example, in a draft of its most recent revision to IRM 5.8.3, the IRS failed to include the low income processability guidelines it had established in its interim guidance.[78] Similarly, at the time of this writing, the "second review" process has seen less than ten cases since its implementation date. Moreover, the IRS still fails to acknowledge the discrepancies between its current procedures and Policy Statement P-5-100. For example, one key IRM section states that "offers will not be accepted if it is believed that the liability can be paid in full as . . . installment payments extending through the remaining statutory period for collection."[79] This guidance conflicts with the policy that offers are a legitimate alternative to a protracted installment agreement. We do not see how these procedures, if left unchanged, will improve OIC efficiency and effectiveness.

The IRS asserts that offer receipts have actually increased for FY 2009, but does not mention that fewer OICs were accepted in FY 2009 than in FY 2008. The IRS's inventory of open OIC investigations has increased by 40 percent at the conclusion of FY 2009. With more and more taxpayers facing economic uncertainty, it is no surprise that more people would seek resolution to their tax problems via the OIC program. However, the IRS seems to view more receipts yet fewer acceptances as a success. The National Taxpayer Advocate is concerned that the increasing number of offer receipts and a corresponding backlog of inventory signal that the processing of many cases will soon be delayed, or even worse, the IRS will return or reject more offers rather than attempt to resolve them through taxpayer contact and negotiation.

The National Taxpayer Advocate is concerned that the IRS's overly rigid process for evaluating OICs is reflected in its increased embedded quality scores. Our review of the OIC quality review standards reveal that the IRS does not measure accuracy from the taxpayer's

[78] TAS, Systemic Advocacy Management System (SAMS) Work Type ID No. 16332; SB/SE, *Interim Guidance for Low Income Processability Procedures* (Feb. 2, 2009).

[79] IRM 5.8.1.1.3 (Sept. 23, 2008).

point of view but rather that its employees merely followed the required steps. Moreover, these standards place a greater emphasis on process than on flexibility or judgment. The National Taxpayer Advocate also wonders whether customer satisfaction has shown a corresponding increase as that of the IRS's embedded quality scores. We have been unable to tell since the most recent customer satisfaction ratings the IRS provided for this report were from FY 2006. Although we are aware that another survey was initiated in late 2008, the IRS has yet to share a copy of these findings with us. Even so, in 2006 less than half of all taxpayers surveyed were satisfied with the OIC program.[80] Many practitioners at this year's IRS Nationwide Tax Forums echoed dissatisfaction with the program. We believe the offer program will not improve unless the IRS acknowledges and acts upon the tangible comments and suggestions voiced by taxpayers or their representatives. The IRS should not assume a reduction in cycle time for offer dispositions correlates directly with taxpayer satisfaction.

The National Taxpayer Advocate supports the IRS's current efforts in training its employees on collection alternatives, and looks forward to seeing the impact of the OIC training modules added in 2008 and 2009. We disagree with the IRS's assessment of its "robust" training for non-OIC employees. Our review of IRM 5.19 reveals this guidance lacks direction to proactively assist the taxpayer with OIC questions, and suggests that the assistor discuss the OIC only if the taxpayer raises the issue. We are pleased that the IRS understands that the application process requires a substantial amount of supporting documentation. However, we remain concerned that non-OIC employees are not adequately trained to assist taxpayers in gathering this information or completing OIC forms as envisioned in the IRS policy statement. MITRE's preliminary analysis found the 100-step offer process can be daunting for many taxpayers, which makes the need for better assistance even greater. We are hopeful that the continued analysis of the OIC program will concentrate on these needs and that the IRS will allow TAS to assist with any additional training.

The National Taxpayer Advocate is also troubled by the IRS's response to our discussion of OIC documentation requirements. The IRS states that it currently has procedures that direct OIC employees to *verify* as much of the CIS as possible through internal sources. However, we believe that the IRS should not *ask for* or *require* the taxpayer to provide what is obtainable and verifiable through its own systems. We believe the IRS should closely examine the current requirements for supporting documentation, and limit the initial requirements to those items that are critical to an evaluation of an OIC. Additional documentation can always be obtained later in the OIC analysis, based on actual need. Reducing the application requirements not only reduces the burden on taxpayers, but also cuts back on the IRS resources used to handle and evaluate the "excess" documentation.

The National Taxpayer Advocate remains concerned with the IRS's OIC lien filing policy, particularly in situations where the IRS accepts an offer that will not be immediately full

80 IRS, SB/SE Research, *Offer in Compromise (OIC) Customer Satisfaction Survey Research Report – Project FTL0023* (Aug. 2006).

paid.[81] The IRS will generally file liens against taxpayers where their liabilities exceed $5,000 and their offers are payable in six months or more.[82] The notice of federal tax lien (NFTL) harms taxpayers' credit eligibility and may remain on credit reports for up to seven years after the IRS releases its lien.[83] The IRS files NFTLs even though taxpayers may not have any property upon which competing creditors would seek liens. The National Taxpayer Advocate believes the IRS should generally not file liens in these cases and, if a lien is filed, should withdraw, rather than release, its liens against taxpayers after paying the offer amount in full.

The National Taxpayer Advocate is pleased that the IRS attempts to make acceptance determinations consistent with the taxpayer's ability to pay and is considering revising its procedures concerning dissipated assets. Further, we appreciate that the IRS instructs its OIC employees to resolve cases following an offer rejection. However, we still see this as an area where improvements are needed. While the OIC employee has an interest in resolving a case through an offer, he or she may not determine the proper resolution (outside of an OIC) unless the employee is directly responsible for the final collection outcome. Moreover, the IRS is misguided in its belief that it is not efficient to have revenue officers consider offers as part of their duties. As it currently stands, the RO simply sends the offer forward to an offer examiner or specialist without any stake in its acceptance or rejection. Only by incorporating a sense of total accountability for the entire case and providing seamless, "one stop" customer service within the OIC process will the IRS achieve maximum efficiency for its Collection program.

The IRS is currently evaluating its authority to regulate or discipline an unenrolled or unlicensed preparer.[84] However, the IRS can require all paid preparers to identify themselves or sign Form 656 or Form 433-A, without a legislative change. The IRS could use this information to gather data to justify a legislative change or to enforce the provisions of IRC § 7206(5) concerning the willful concealment of property or withholding, falsifying or destroying records in connection with an offer. Moreover, the IRS can clarify whether *preparing* a Form 656 or Form 433-A or B constitutes representation before the IRS.

In closing, the National Taxpayer Advocate reiterates that OICs can be a viable collection option for the IRS and taxpayers. A successful OIC program begins with effective communication, better assistance for and education of taxpayers before their offers are submitted, greater emphasis on personal contact rather than written correspondence during the OIC investigation, and continuing service for taxpayers who are willing to comply but for whom an offer is not the most appropriate option. The IRS needs to look no further than its existing OIC policy statement, past OIC successes, the National Taxpayer Advocate's

81 *See* Legislative Recommendation: *Strengthen Taxpayer Protections in the Filing and Reporting of Federal Tax Liens, infra.*

82 IRM 5.8.4.9 (Sept. 23, 2008).

83 *See* Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of Law, Fail to Promote Future Tax Compliance and Unnecessarily Harm Taxpayers, supra.*

84 *See* Most Serious Problem: *The IRS Lacks a Servicewide Return Preparer Strategy, supra.*

recommendations, and more importantly, its customers' voices to bring the OIC program and its entire collection program back into proper balance.

Recommendations

The National Taxpayer Advocate recommends that the IRS take the following specific actions:

1. Reinstate its 1992 procedures to more closely follow Policy Statement P-5-100;
2. Recommend OICs consistent with the collectibility curve to taxpayers whose tax liabilities have aged more than three years;
3. Place the ability to work and accept OICs back in the revenue officer's collection toolkit and provide one-stop service for taxpayers whose offers are rejected, *e.g.*, have revenue officers or other employees grant IAs or report accounts CNC after OIC rejection;
4. Revise Form 656 to eliminate substantiation and large amounts of documentation upon submission and create procedures so that Form 656 starts the conversation with taxpayers;
5. Change procedures to require that offer processors build an offer file with information the IRS already has, and that offer examiners or offer specialists will explore the possibility of the offer with taxpayers, *e.g.*, RCP, special circumstances, etc., gather additional information, and follow-up with correspondence;
6. Revise and require all paid preparers to sign or identify themselves on Forms 433 and 656; and
7. Clarify that preparation of Forms 433 and 656 constitutes representation before the IRS, and inform taxpayers to use only Circular 230 representatives with respect to OICs.

MSP #15

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

RESPONSIBLE OFFICIALS

Richard E. Byrd Jr., Commissioner, Wage and Investment Division
Chris Wagner, Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

The IRS continues to miscalculate collection statute expiration dates (CSEDs) and has not addressed lengthy CSEDs on certain taxpayer accounts. As of September 24, 2009, over 4,600 taxpayers had accounts with CSED extensions that would violate IRS policy if entered into today.[1] Moreover, a review of collection-related cases in TAS inventory found that over 60 percent contained one or more miscalculated CSEDs.[2] A further review of split spousal assessments revealed that approximately one-half had incorrect CSEDs.[3]

Generally, the IRS must collect a taxpayer's liability within ten years after it is assessed.[4] By statute, various conditions and agreements suspend or extend the period for collection. When it miscalculates a CSED, the IRS may take unnecessary action and force taxpayers to overpay or underpay their tax liabilities. The National Taxpayer Advocate has the following concerns with the IRS's CSED policies and procedures:

- Taxpayer accounts with excessively long CSED extensions, combined with the IRS's lack of procedures to resolve these accounts, lead to disparate treatment for many taxpayers;
- Delays in identifying and fixing erroneous CSEDs burden taxpayers, hamper the collection process, and lead to IRS rework;
- Limited training involving CSED issues and employees who lack skills to properly calculate CSEDs cause erroneous CSEDs; and
- A lack of centralization for CSED issues prolongs case resolutions.

1 TAS Research data from IRS Compliance Data Warehouse (CDW) extract (Sept. 24, 2009).

2 TAS reviewed an anecdotal sample of 50 cases for CSED accuracy.

3 This data was obtained from an extract of cases from Master File Tax (MFT) 31. These are cases in which the taxpayers' account is split between spouses due to the IRS's need to track their accounts separately. The reviewed cases were split prior to January 1, 2005, and contained a restricted interest transaction with a related transaction (usually bankruptcy, and offer in compromise (OIC) cases).

4 Internal Revenue Code (IRC) § 6502(a)(1).

ANALYSIS OF PROBLEM

Background

The CSED is the date that the IRS must cease taking collection actions on a taxpayer's account. The CSED may be extended if a proceeding in court has begun, if the IRS and the taxpayer agree to extend the collection statute upon entering into an installment agreement (IA), or if the taxpayer and the IRS agree to extend the collection statute as part of a levy release.[5] Other case actions also may suspend or extend a CSED, including:

- Bankruptcy;[6]
- Judgment or litigation when a taxpayer's assets are under a court's control;[7]
- Collection Due Process (CDP) appeal;[8]
- Offers in compromise (OIC);[9]
- Relief from joint and several liability on a joint return;[10]
- Taxpayers living outside the United States;[11]
- Wrongful seizure or wrongful lien;[12] or
- Military deferment.[13]

The IRS uses Form 900, *Tax Collection Waiver*, to extend the CSED on accounts beyond the ten-year period for collections.[14] Before November 1995, the IRS secured these waivers on any account and for any duration provided the CSED was open.[15] The IRS subsequently revised its policy and procedures to limit CSED extensions entered with an IA to five years.[16]

In April 1998, the IRS Assistant Chief Counsel (General Litigation), in a memorandum to the Chief Counsel, concluded that IAs that partially paid the liability within the CSED were not permitted under the law.[17] Six years later, Congress amended IRC § 6159 as part of the

5 IRC §§ 6502(a)(2) and 6331(k).

6 IRC § 6503(h).

7 IRC § 6503(b). Further, IRC §§ 6331(i)(5) and 6503(a) provide that the running of the statutory period for collection is suspended during periods in which the IRS cannot levy upon the taxpayer's assets.

8 IRC § 6330(e).

9 IRC § 6331(k).

10 IRC § 6015(e)(2).

11 IRC § 6503(c) (the CSED shall be suspended for the period during which the taxpayer is outside the United States if such period is continuous for at least six months).

12 IRC § 6503(f).

13 IRC § 7508(a) (the period of service by a member of the armed services while serving in a "combat zone" or in a "contingency operation," or while hospitalized as a result of such activity, plus 180 days, shall be disregarded for purposes of determining the CSED).

14 Form 900, *Tax Collection Waiver* (rev. Apr. 2003).

15 *See* Internal Revenue Manual (IRM) 53(11)(1) (Oct. 28, 1993) (stating, "The ten year collection period may, at any time prior to its expiration, be extended for any period of time agreed upon by the taxpayer and the district director," but not providing any guidance on how employees should use CSED waivers).

16 IRM 5331.1(12)(b)2 (Nov. 2, 1995).

17 IRS Chief Counsel, *Partial-Payment Installment Payment Agreements* (Apr. 20, 1998), as referenced by H.R. Rep. No. 108-755, at 649 (2004).

American Jobs Creation Act of 2004 to permit the IRS and taxpayers to enter into partial payment installment agreements (PPIAs). Now, the IRS will only secure CSED waivers in connection with PPIAs for a maximum of five years.[18]

Until 1998, the IRS routinely secured CSED extensions from taxpayers on all accounts, including those deemed currently not collectible (CNC).[19] Congress eliminated these extensions as part of the IRS Restructuring and Reform Act of 1998 (RRA 98). Congress believed the IRS was forcing taxpayers into lengthy extensions, and that ten years was long enough to collect tax liabilities.[20] The Senate version of RRA 98 proposed to eliminate all CSED extensions, but in a compromise, Congress amended IRC § 6502 to provide that the CSED may be extended in connection with an IA or prior to a levy release after the ten-year period.[21] RRA 98 further provided that most CSED extensions, except for those entered in connection with an IA, would expire on or before December 31, 2002.

The IRS does not properly resolve accounts with excessively long CSEDs.

The National Taxpayer Advocate is concerned that the IRS continues to neglect a group of taxpayers with CSEDs that were unreasonably extended in the past. Before the IRS changed its policy regarding CSED extensions, it was common for IRS Collection personnel to extend collection statutes for periods as long as ten, 20, 30, 40, or even 50 years in conjunction with an IA.[22]

Example

The IRS assessed liabilities against a taxpayer for several tax years prior to 1996 with the earliest CSED expiring in 2000. In 1997, the IRS's Automated Collection System (ACS) determined the taxpayer could pay $200 per month against the liabilities of over $50,000. An ACS employee gave the taxpayer a choice: the IRS could levy her wages or she could agree to extend the CSED until 2020 in connection with an IA – an extension of 20 years. Nine years after the original CSED, the taxpayer has made most of her IA payments, but due to fluctuating interest rates and penalty accruals she cannot satisfy her liability by the extended CSED and still faces 11 more years of payments.

18 IRM 5.14.2.1.3 (Sept. 26, 2008). When taxpayers have some ability to pay, but cannot pay their tax liabilities in full before the CSED expires, the IRS may allow them to enter into PPIAs. IRM 5.14.2.1 (Sept. 26, 2008).

19 Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3401, 112 Stat. 685 (now codified as IRC § 6502(a)). National Taxpayer Advocate 2004 Annual Report to Congress 182.

20 H.R. Rep. No. 105-364, at 69-70 (1998); Joint Tax Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1998* 106 (Nov. 24, 1998). 144 Cong. Rec. S4147-01, S4184 (May 4, 1998) (statement of Sen. Roth).

21 IRC § 6502(a)(2). Even though the IRS currently has no procedures or regulations regarding the extension of a CSED in connection with a levy release, the IRS may secure a CSED waiver in connection with a release of levy. Under this provision, the IRS could extend the CSED in cases where the IRS served a levy on a fixed and determinable right, *e.g.*, pension payment, Social Security payments, or trust fund payments of the taxpayer, but had to release the levy due to hardship after the ten-year period had run. *See* National Taxpayer Advocate 2006 Annual Report to Congress 527-30.

22 National Taxpayer Advocate 2006 Annual Report to Congress 520.

Many taxpayers with lengthy CSEDs owe more on their accounts than when they entered into their IAs. Yet in other cases, taxpayers have stopped making payments altogether.[23] The IRS has had problems tracking these CSEDs, causing inaccuracies in these accounts.[24] Moreover, other taxpayers appear to have entered into CSED extensions exceeding the five years permitted under IRS procedures.[25]

Table 1.15.1 shows the results of TAS's research and analysis of taxpayers with CSED extensions exceeding ten years (as reviewed since September 1, 2008). The table further demonstrates that in the past year the IRS has not received a payment, either voluntary or involuntary, from three out of every four of these taxpayers. This research underscores the need for the IRS to resolve these accounts.

TABLE 1.15.1, Taxpayers with Lengthy CSED Extensions[26]

Extension Period	With no Payment since Sept. 1, 2008	% of Total	With Payment since Sept. 1, 2008	% of Total	Total
10-19 years	1,900	76.7%	576	23.3%	2,476
20-29 years	1,311	79.0%	348	21.0%	1,659
30-39 years	290	84.1%	55	15.9%	345
40-49 years	70	77.8%	20	22.2%	90
50 or more years	84	83.2%	17	16.8%	101
	3,655	78.2%	1,016	21.8%	4,671

While RRA 98 eliminated most lengthy CSED extensions as of December 31, 2002, taxpayers who were willing to enter into an IA with the IRS have not received the same relief. The IRS's Collection division has agreed to work with TAS to identify cases with pre-RRA 98 extended CSEDs, and consider resolving them once and for all.

Delays in identifying and fixing erroneous CSEDs burden taxpayers, hamper the collection process, and lead to IRS rework.

The National Taxpayer Advocate's 2004 Annual Report to Congress indicated that the IRS had thousands of taxpayer accounts with miscalculated CSEDs.[27] The incorrect CSEDs were the result of IRS systems errors and limitations, and employees' erroneous calculations. TAS and the IRS participated in a CSED task force from 2004 through 2006 to address issues that could be resolved through programming, IRM changes, or training.

23 National Taxpayer Advocate 2006 Annual Report to Congress 524.

24 *Id.* at 525.

25 Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2001-10-103, *Improvements Are Needed to Comply with Legal and Procedural Requirements for Collection Statute Extensions and Installment Agreements* 5 (Aug. 2001) (indicating that over three percent of a sample of 1,866 tax modules with taxpayer CSED extensions entered in connection with IAs exceeded the policy limit of five years).

26 TAS Research data from IRS Compliance Data Warehouse (CDW) extract (Sept. 24, 2009).

27 National Taxpayer Advocate 2004 Annual Report to Congress 180.

Despite the efforts of the task force, the IRS continues to burden taxpayers with delays in identifying and correcting erroneous CSEDs. Our analysis of split spousal assessments revealed that approximately half the accounts had incorrect CSEDs.[28] Cases with miscalculated CSEDs tend to be more complex and often involve multiple factors affecting the CSED calculation. Consider the following:

Example 1

Married taxpayers filed a joint return. The taxpayers subsequently separated and the husband filed for bankruptcy but the wife did not. The bankruptcy extended the collection statute beyond the ten-year period for the husband.[29] The CSED expired for the wife approximately two years ago, but the IRS improperly levied on her Social Security benefits to collect the tax liability. The IRS must correct the CSED and refund the levy proceeds.

Example 2

Married taxpayers each submitted OICs to resolve a few years of tax liabilities. Even though the taxpayers withdrew both offers, each OIC extended the length of the CSED. The taxpayers then entered into an IA and signed a Form 900 waiver, which also extended their CSEDs. Further, the IRS split their accounts after assessing individual civil penalties (which contained different CSEDs for each taxpayer).[30] The taxpayers contacted the IRS to find out the actual CSEDs for their various accounts and to determine how to resolve them. The IRS could not provide a satisfactory answer, so the taxpayers sought assistance from TAS.

TAS must submit numerous requests to the IRS operating divisions and functions to resolve CSED problems. We recently reviewed 50 collection-related cases in TAS inventory to determine the extent of incorrect CSED calculations. Thirty-three of the 50 cases involved multiple issues that could affect the CSED, and 31 of them contained one or more miscalculated CSEDs.[31] The IRS practice of having different units handle different parts of a taxpayer's case compounds this problem. If a taxpayer receives a bankruptcy discharge, obtains an IA to pay the balance due, and then decides to submit an OIC, all three actions affect the CSED. However, only the unit responsible for a particular CSED error will correct it. While some taxpayers may be able to navigate the IRS to resolve a CSED issue, most never discover the issue until they receive assistance from a tax preparer or TAS employee, usually in conjunction with another issue. By that time, they may have overpaid their account or suffered economic harm. While the IRM does provide guidance on which types of

28 TAS conducted a random sample of MFT 31 (Split Spousal Assessment) cases split prior to January 1, 2005, which contained a restricted interest transaction, which is a transaction code TC340. The TC340 carries its own CSED, thus the split cases with this particular coding series were cases at high risk of having inaccurate CSEDs. TAS reviewed a sample of 230 out of approximately 3,000 cases. See Most Serious Problem: *The IRS Mismanages Joint Filers' Separate Accounts, infra.*

29 IRC § 6502(a)(1).

30 *See* Most Serious Problem: *The IRS Mismanages Joint Filers' Separate Accounts, infra.*

31 TAS review of CSED cases from an anecdotal sample.

actions can suspend or extend a CSED, the IRS offers no specific guidance to ACS assistors or other front line employees to solve CSED problems.[32]

Limited training and unskilled employees cause erroneous CSEDs.

The National Taxpayer Advocate acknowledges that calculating CSEDs can be tedious and that changes to the tax laws have added layers of complexity to the process. Many IRS employees appear to lack the skills to identify an erroneous CSED, much less accurately compute one. Accordingly, these employees dutifully follow the CSED information noted on the Integrated Data Retrieval System (IDRS) without verifying the accuracy of this data.[33] The IRS has an automated CSED Computation Worksheet that with proper use can help determine the correct CSED even on complex cases. However, the worksheet is only available by searching for "CSED calculation" on the IRS intranet and is not officially authorized for all IRS functions.[34]

Moreover, the IRS lacks adequate training on CSED issues. Only the Wage and Investment (W&I) operating division and the IRS OIC program appear to have training modules dedicated to calculating CSEDs.[35] W&I training modules target tax examiners and customer service representatives and comprise the basics of resolving CSED cases, but do not specify how to handle complex CSED issues. The IRS should adopt a comprehensive training plan to identify and improve the handling of miscalculated CSEDs. The National Taxpayer Advocate is willing to partner with the IRS to develop and present this critical CSED training.

Lack of centralization for CSED issues prolongs case resolutions.

The IRS can improve customer service and protect taxpayer rights by dedicating the appropriate resources to identify and resolve CSED issues. In certain situations, taxpayers can benefit when the IRS centralizes its processes to serve them, *e.g.*, its centralized units for assessment statute and refund statute expiration issues.[36] These units allow the IRS to handle both routine and complex issues without transferring cases. In contrast, the IRS transfers CSED cases to the specific business unit that caused the problem, which results in multiple transfers of accounts and will not correct the problem if the case never reaches the right unit. Taxpayers or their representatives should be able to contact the IRS for resolution of CSED problems without such transfers.

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32 See generally IRM 5.1.19, *Field Collection Procedures, Collection Statute Expiration* (June 4, 2009), and IRM 8.21.5.4 (June 1, 2007) for Appeals procedures.

33 In some cases there is no CSED indicated at all on Integrated Data Retrieval System (IDRS) information pages, which further complicates the IRS's ability to determine the correct CSED.

34 Automated CSED Computation Worksheet (May 2009).

35 W&I *Learning and Education – Resolving Statute Cases (6686)*, Training 12241-102 (Feb. 2008); *MOIC Collection Statute Training (49606Q)*, Training 22434-102 (Dec. 2006).

36 National Taxpayer Advocate 2008 Annual Report to Congress 262-63. There are many valid, taxpayer-friendly reasons to centralize a program. Through centralization, the IRS can immediately resolve inconsistencies and create efficiencies that might not be apparent if performed by separate divisions. Further, centralization allows the IRS to coordinate and consolidate equipment, processes, and technology.

CONCLUSION

The IRS has made some improvements in dealing with erroneous or problematic CSED cases. However, it needs to eliminate lengthy CSEDs that are contrary to its policies and the law and establish procedures to rectify erroneous CSEDs. The IRS must provide better service to taxpayers and accountability for its operating divisions to quickly discover and resolve CSED problems.

In order for the IRS to resolve these CSED problems, the National Taxpayer Advocate offers these preliminary recommendations:

1. Permanently resolve cases with excessively long CSEDs;
2. Provide comprehensive training and continuing education to all employees who work with CSEDs;
3. Develop systems that can identify CSED problems so they can be resolved quickly; and
4. Establish a centralized CSED unit to work difficult cases.

IRS COMMENTS

The vast majority of taxpayers with unpaid tax assessments resolve their tax liabilities within the established ten-year CSED. In 2008, nearly 81 percent of the 16.9 million accounts for which the IRS issued an initial delinquency notice were resolved before the account was assigned to an IRS collection stream for resolution.[37] Further, approximately one half of one percent (0.53 percent) of unpaid assessment installment agreement modules involve periods that are over ten years old.[38]

In a relatively small number of collection cases, the statutory period for collection may be extended, by mutual agreement, between the taxpayer and the IRS. As the National Taxpayer Advocate states in this report, since 2004, the IRS has adopted a policy in which CSED extensions are only secured on PPIA cases. The extension cannot exceed five years and is done only in very limited instances. Of the 22,555 PPIAs executed in fiscal year 2008, we extended the statute in only 88 of these cases.[39]

In some instances, the CSED may be suspended when the IRS is statutorily prohibited from pursuing collection of the liability.[40] Taxpayer-initiated activities, such as filing for bankruptcy protection, submitting an offer in compromise, or requesting a collection due process hearing result in the suspension of the collection statute. The suspension of the

37 IRS, *CAR Report* 5000-2/242 TDA Balance Due Notices, *BDN Report IMF & BMF Receipts*, col. g & n and *BDN Dispositions - BDN Report IMF & BMF*, lines 2.1-2.1.5.

38 Business Performance Management System, unpaid assessment model.

39 IRS, Collection Activity Report NO-5000-6, line 1.1.20 National Report. All Form 900 extensions on PPIAs are processed through Centralized Collection Process and manually counted.

40 IRC § 6503 (a)(b).

collection statute provides the IRS with a counterbalance to the relief from collection activity taxpayers are provided during the suspension periods.

The IDRS is programmed to correctly compute the CSED and does so for balance due cases. Even in situations for which the statute is suspended, IDRS is able to correctly compute the correct CSED for most cases. There are cases in which taxpayers who are unable or unwilling to pay can initiate several actions throughout the life of the case that result in multiple suspensions of the statute. For example, a taxpayer can file a collection due process hearing, subsequently file an offer in compromise, and subsequently file bankruptcy. All of these actions suspend the collection statute for varying periods of time and must be considered when determining the correct CSED.

The IRS is confident that IDRS is able to correctly compute the CSED for the large majority of balance due cases. Therefore, in-depth CSED computation training is not appropriate for all contact employees. Training on CSED computations is delivered to employees at varying times and levels based on their job duties. All contact employees receive basic CSED training, while other employees receive more in-depth training based upon the needs of their particular position and potential for exposure to complex CSED computations. The National Taxpayer Advocate identifies an automated CSED computation worksheet that could assist employees in computing the proper CSED on an account. This worksheet was reviewed by a 2004 task force, but was not adopted at that time due to problems identified during informal testing. The worksheet has been revised since 2004 and we are in the process reevaluating and completing formal testing of this product to determine its effectiveness and usability.

The National Taxpayer Advocate highlights a number of cases in which she believes the collection statutes were unreasonably extended. The IRS reviewed a number of these cases and, in a majority of the cases, the decisions to extend the CSED were appropriate. Nevertheless, the IRS will review cases with questionable CSED extensions to determine whether circumstances exist under which the IRS should consider alternative resolution options.

The National Taxpayer Advocate makes four preliminary recommendations to resolve CSED problems. The IRS is taking the following actions with respect to these recommendations:

As noted above, we will review cases with questionable CSED extensions to determine whether circumstances exist under which the IRS should consider alternative resolution options.

The IRS believes that it delivers an appropriate level of CSED training to employees. However, we will review our collection statute training modules to identify and address any potential training gaps.

While the IRS believes that current systems accurately compute the CSED, we will monitor the accuracy of the computations and initiate programming changes as problems are identified. Additionally, the IRS will continue to work with the National Taxpayer Advocate to correct CSED issues on accounts where the tax liability was split as a result of a bankruptcy, OIC, Appeal, or an innocent spouse situation by one or both parties of a joint liability.

The IRS does not believe a centralized unit to work difficult CSED cases is necessary at this time. We will continue to explore opportunities to improve the timeliness and accuracy of case resolutions when complex statute suspensions or extensions exist.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate agrees with the IRS's assertion that nearly 80 percent of all balance due accounts are resolved during the notice stage and as a result, will not lead to possible CSED problems. We are encouraged that less than one-half of one percent of all existing IAs contain lengthy CSEDs. Moreover, the National Taxpayer Advocate commends the IRS for correctly computing the CSEDs on most taxpayer accounts and is pleased that the IRS adheres to the 2004 policy of securing CSED extensions only in conjunction with PPIAs.

However, the National Taxpayer Advocate is deeply troubled by the IRS's response with respect to taxpayers with excessively long CSEDs extended before RRA 98. Taxpayers in this situation are being unduly harmed. The number of taxpayers affected, whether 4,700 or just one, should not deter the IRS from fixing this problem. Today, the IRS would be barred from entering into installment agreements with CSED extensions exceeding five years, absent other extensions allowed by law. In its response, the IRS has attempted to justify its actions by citing its legal right to take those actions in the past. Instead, the IRS should do the right thing in the present and, in the spirit of fair and equitable treatment for all taxpayers, take immediate steps to resolve these excessively long CSEDs.

The IRS Must Improve its Transparency Regarding Lengthy CSEDs

The National Taxpayer Advocate is disappointed that although the IRS states it has reviewed TAS's sample of cases for taxpayers with CSEDs extended beyond the original CSED plus five years, as of this writing the IRS has not shared the findings with us. We have asked to see the results several times, but the IRS has not been forthcoming with a

copy of its report.[41] It appears that the IRS has discovered from its review that the notices of federal tax lien (NFTLs) filed against these taxpayers have self-released and have not been refiled in some cases. If this is true, we are surprised that the IRS would direct its employees to step up efforts to harm these taxpayers after we asked them to help resolve these cases.[42] The IRS should eliminate these cases once and for all rather than prolonging the harm to taxpayers by refiling an NFTL.[43] If the IRS is not prepared to take this action, it should review each and every case with an excessively long CSED. In cases with flagrant conduct (more than the taxpayer merely not paying because the IRS is not pursuing collection), the IRS should work the case, *i.e.*, take the necessary actions to collect the balance due.[44] Otherwise, the IRS should terminate the extension, write off the debt and release and withdraw the NFTL as appropriate.[45]

Improve the Ability of IDRS to Calculate CSEDs

The National Taxpayer Advocate agrees that the IDRS is programmed to correctly compute the CSED for many balance due cases. However, we disagree that the IDRS can correctly compute the CSED even in situations for which the statute is suspended. We continue to identify accounts with incorrect CSEDs and note that many of these cases have multiple issues affecting the CSED, such as bankruptcy and pending OICs. While the National Taxpayer Advocate is pleased that the IRS has agreed to work with TAS to correct problematic accounts, we believe the IRS should be more proactive in dealing with CSED problems.[46] To be more proactive, at a minimum the IRS should train its employees to identify the complex issues that affect CSEDs, alert taxpayers when the accuracy of a CSED is questionable, and direct these taxpayers to the various functions that can resolve their cases.

Implement the Automated CSED Computation

The National Taxpayer Advocate is encouraged that the IRS is reviewing the automated CSED Computation Worksheet. The IRS should develop this worksheet or some variation of it to the point that it will be used by all employees responsible for computing CSEDs. We are willing to work with the IRS to assist in evaluating and testing this potentially valuable tool and in facilitating the prompt implementation if warranted.

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41 On November 2, 13, 17 and December 8, 2009, TAS e-mailed representatives of IRS Collection Policy to inquire whether a report generated from case data for taxpayers with lengthy CSEDs submitted in an email dated June 22, 2009, would be disclosed to TAS. Prior to printing, we requested the report and were advised that the SB/SE division had concerns about this report, and notwithstanding the IRS's citing it in the response to our analysis, the report will be shared with senior leadership instead.

42 SB/SE, *Policies and Procedures for NFTLs first filed after CSEDs, Including Release and Refiling Considerations* (Oct. 14, 2009).

43 *See* Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of the Law, Fail to Promote Future Tax Compliance, and Unnecessarily Harm Taxpayers, supra.*

44 See IRM 5.11.6.2 (Mar. 15, 2005) for examples of flagrant conduct.

45 See Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of the Law, Fail to Promote Future Tax Compliance and Unnecessarily Harm Taxpayers, supra*, for an explanation of the difference between a lien release and a lien withdrawal.

46 *See* Most Serious Problem: *The IRS Mismanages Joint Filers' Separate Accounts, infra.* The IRS trained a specialized project team to resolve MFT31 issues and is developing an automated system to fix these accounts.

Centralize the CSED Process

The National Taxpayer Advocate is disappointed in the IRS's position that a centralized CSED unit is unnecessary. We believe a centralized unit would benefit the IRS by providing a much-needed resource for employees attempting to efficiently resolve complex CSED accounts. Further, taxpayers will benefit from a centralized unit by having access to highly trained employees, which should result in more favorable resolution of cases and reduce the time needed to resolve these cases. The unit's staff could also serve as subject matter experts to develop and provide training to other employees with varying levels of CSED knowledge and needs. We are hopeful the IRS will reconsider this decision since it has already achieved improved efficiency from similar centralized functions, such as the restricted interest or assessment statute expiration date centralized functions.

In summary, the National Taxpayer Advocate believes it is imperative that the IRS improve its programming for CSED computations and provide adequate training and oversight of all employees and programs related to CSEDs. The IRS should dedicate the necessary resources and systems to compute CSEDs accurately on all accounts, and should immediately review and resolve all of the accounts with CSEDs over 15 years that TAS has identified. Otherwise, more taxpayers will find themselves undergoing needless IRS collection actions or in need of TAS assistance.

Recommendations

The National Taxpayer Advocate recommends that the IRS:

1. Permanently resolve excessively long CSEDs by writing off any balance due on accounts with CSEDs greater than the original CSED plus five years (absent other extensions allowed for by law).
2. Provide comprehensive training and continuing education to all employees who work with CSEDs so they can identify problematic CSED cases to refer to a centralized CSED unit;
3. Develop systems that can identify CSED problems so they can be resolved quickly; and
4. Establish a centralized unit to work difficult CSED cases.

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

RESPONSIBLE OFFICIALS

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Chris Wagner, Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

The number of bankruptcy filings in the United States has increased by 31 percent from calendar year 2007 to 2008.[1] This trend is consistent with the increase in IRS bankruptcy cases. The IRS's statistics reflect an 18 percent increase in insolvency, *i.e.*, bankruptcy, inventory between October and November of fiscal year (FY) 2009 over the same time period for FY 2008 and a 47 percent increase over the same time period for FY 2007.[2] For Chapter 11 cases (a form of reorganization used primarily by business enterprises), the IRS's statistics reflect an 88 percent increase over FY 2008.[3]

The effect of bankruptcy law on tax debts is often confusing to taxpayers and their representatives. Taxpayers looking for a fresh start may be surprised to learn that not all taxes are dischargeable and that nondischargeable tax debts can sometimes be collected post-bankruptcy. Even if the tax is discharged, the IRS can collect the discharged tax by enforcing its lien interest on exempt, abandoned, or excluded property.

Given the mounting number of bankruptcies, the IRS should reevaluate its bankruptcy procedures and policies to ensure they are easy for taxpayers to understand and do not impair the taxpayer's future compliance and the "fresh start" goal of bankruptcy. By taking a holistic approach to the taxpayer's circumstances, the IRS may use the post-bankruptcy period as an opportunity to bring formerly noncompliant taxpayers into compliance and keep them in compliance.

1 United States Bankruptcy Court at http://www.uscourts.gov/Press_Releases/2009/bankrupt_ftable_dec2008.xls (last visited Oct. 19, 2009). The number of total bankruptcy filings in calendar year 2007 was 850,912 and the total of filings in calendar year 2008 was 1,117,771.

2 *See* Small Business/Self-Employed Division (SB/SE), *Business Performance Review* (Feb. 2009).

3 *See* SB/SE, *Business Performance Review* (Feb. 2009).

ANALYSIS OF PROBLEM

Background

Introduction to Bankruptcy Law

One of the general purposes of the Bankruptcy Reform Act of 1978[4] (codified in Title 11 of the United States Code) was to provide debtors with a fresh start. Bankruptcy is intended to give debtors an opportunity to pay an affordable amount of their debts while receiving debt forgiveness.[5] There are several avenues by which different types of debtors can obtain a fresh start.[6] These different avenues appear in different chapters in the Bankruptcy Code. The most common include:

- **Chapter 7.** Individuals, corporations, and partnerships can file for Chapter 7 relief. In a Chapter 7 proceeding, the debtor relinquishes all non-exempt or excluded assets to the bankruptcy trustee to be liquidated. This proceeding may be identified as an asset or no-asset proceeding. In a no-asset proceeding, there are no assets to be liquidated, and thus no proofs of claim are filed. However, the individual debtor may still receive a discharge.[7]
- **Chapter 11.** Individuals, corporations, and businesses may file for Chapter 11 protection, which allows them to reorganize and pay creditors according to a long-term court approved plan.[8]
- **Chapter 13.** Individuals with regular income who meet certain debt limitations for secured and unsecured debt may file for Chapter 13 protection. The debtor has the opportunity to retain control of assets and to reorganize under a plan meeting certain requirements for repayment of debts approved by the court. The debtor makes the plan payments to the trustee for disbursal to creditors.[9]

Once a debtor files a petition with the United States Bankruptcy Court under one of these chapters, the law prohibits creditors (including the IRS) from taking certain collection actions and protects certain assets from liquidation.[10] This prohibition on collection is known as the automatic stay.

Congress carved out exceptions and exclusions for liquidation of certain assets to leave taxpayers with the necessities essential to rebuild their financial lives.[11] These assets include:

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4 Pub. L. 95-598, 92 Stat. 2549 (1978).

5 For more details on the structure of the Bankruptcy Code, see William D. Elliott, *Federal Tax Collections, Liens and Levies* ¶ 20.03 (2009).

6 There is also bankruptcy relief for family farmers and fishermen under Chapter 12, entitled *Adjustment of Debts of a Family Farmer or Fisherman*. This chapter provides debt relief to family farmers and fishermen with regular annual income by allowing them to repay creditors under a three to five year plan.

7 11 U.S.C.A. § 727(a).

8 11 U.S.C.A. § 1141(d).

9 11 U.S.C.A. § 109(e).

10 11 U.S.C.A. §§ 362 and 522.

11 11 U.S.C.A. §§ 522 and 541.

- **Exempt property.** Common exemptions are the homestead exemption and exemptions for automobiles.
- **Excluded property.** Certain property may be excluded from the bankruptcy estate by law, such as funds placed in an Employee Retirement Income Security Act (ERISA) qualified retirement plan.
- **Abandoned property.** Property determined by the bankruptcy trustee to be of inconsequential value or overly burdensome to administer.[12]

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA)[13] requires Chapter 13 debtors to be in filing compliance with the IRS for four years before the bankruptcy petition, and also requires taxpayers to file returns or an extension for returns due during the commencement of bankruptcy.[14] If a taxpayer fails to meet post-petition tax return filing obligations, the court can convert or dismiss the case upon request of the IRS.[15]

The Interaction of Tax and Bankruptcy Law

Although one main purpose of bankruptcy is to help the debtor obtain a fresh start through the discharge of debts, this goal may not always be achieved because certain debts are nondischargeable, *e.g.*, domestic support obligations. Certain federal tax debts are nondischargeable because the system must balance two conflicting principles – one where taxpayers are obligated to pay taxes and another where debtors can make a fresh start via bankruptcy. A taxpayer filing for bankruptcy needs to understand the impact this action will have on his or her tax liabilities.

Statutory liens for taxes arise under Internal Revenue Code (IRC) § 6321 any time the IRS assesses tax and the taxpayer does not pay the assessment within ten days of demand for payment. This is often called the "secret" federal tax lien. For further protection of the liability, the IRS can also file a notice of federal tax lien (NFTL). By filing an NFTL, the government protects its right of priority against certain third parties, typically a purchaser, holder of a security interest, mechanic's lien, or judgment lien creditor.

In general, there are two modes for a creditor to enforce a claim – *in personam* or *in rem*. An *in personam* action is directed toward a particular person, while an *in rem* action is directed toward some specific piece of property. A bankruptcy discharge extinguishes only one mode of enforcing a claim – an *in personam* action – while leaving an *in rem* action intact.[16]

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12 *See* 11 U.S.C.A. § 522(d); 11 U.S.C.A. § 541(c)(2) and (b)(5) and (6); 11 U.S.C.A. § 554.

13 Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005).

14 11 U.S.C. §§ 1307(e) and 1308.

15 11 U.S.C.A. 521(j).

16 11 U.S.C. § 524 (a) (2); *Johnson v. Home State Bank*, 501 U.S. 78 (1991).

The IRS can still collect from a taxpayer who has gone through bankruptcy and received a full discharge from all federal tax debts if there is a pre-petition tax lien on the taxpayer's exempted, excluded, or abandoned property.[17] However, a pre-petition NFTL is not required to collect taxes discharged in bankruptcy against assets that were *excluded* from the bankruptcy estate. For example, a taxpayer who owes pre-petition taxes files bankruptcy before an NFTL is filed and a retirement account is excluded from the bankruptcy estate. The statutory "secret" lien will survive bankruptcy with respect to the excluded retirement account.[18]

For *exempt* and *abandoned property*, a valid NFTL must be filed before the petition in order for the lien to survive bankruptcy.[19] If an NFTL is filed, any liens on these assets survive bankruptcy and remain attached to the exempt or abandoned assets. The IRS may collect on these assets by foreclosing its lien interest.[20] Thus, the general goal of bankruptcy, providing a fresh start through the discharge of debts, will not be achieved if certain tax debts survive the bankruptcy, unless those debts are otherwise resolved.

IRS Procedures for Nondischargeable and Dischargeable Tax Debts Post-Bankruptcy

Generally, once a bankruptcy petition is filed, all collection against the debtor stops until the automatic stay is lifted, *i.e.,* the bankruptcy case is closed, dismissed, or a discharge is granted or denied.[21] When the proceeding is complete, the IRS separates out collection activity into two functions – one for dischargeable debts and one for nondischargeable debts. *Nondischarged* debts are returned to the normal collection stream. *Discharged* tax debts go through a separate process that includes screening of both real and personal property for the possibility of collecting from assets exempted, excluded, or abandoned from the bankruptcy proceeding, if certain dollar thresholds are met.[22]

Normally, the IRS has 30 calendar days from notification of discharge to release NFTLs where all periods have been satisfied or have become legally unenforceable.[23] However, the release of the lien may be delayed while the IRS Field Insolvency organization investigates to determine if there is any collection potential with respect to exempt, abandoned, and excluded assets. The investigation can take an undetermined amount of time, during

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17 11 U.S.C. §§§ 522, 541, and 554; *In re Isom*, 901 F.2d 744 (9th Cir. 1990).

18 11 U.S.C. § 523(a)(1).

19 11 U.S.C. § 522(c)(2)(B).

20 IRC § 524(a)(1).

21 11 U.S.C § 362. Section 362(n), which was added by BAPCPA, provides that the stay will not go into effect in certain abusive serial filing situations by small business debtors. Further, the filing of a bankruptcy petition will not operate as a stay of an audit by a governmental unit to determine tax liability; the issuance to the debtor of a notice of tax deficiency; a demand for tax returns; or the making of an assessment for any tax and issuance of a notice and demand for payment of such an assessment. 11 U.S.C. § 362(b)(9). The automatic stay also does not bar the set-off of a pre-petition tax refund against a pre-petition liability. 11 U.S.C. § 362(b)(26).

22 IRS response to TAS information request (July 23, 2009).

23 Internal Revenue Manual (IRM) 5.9.17.18 (May 16, 2008).

which the NFTL remains in the public record.[24] The IRS has 30 days to release the lien from the time the investigation is complete.[25] If the investigation finds exempt, excluded, or abandoned real property, the IRS will not release NFTLs until the investigation into whether the IRS should pursue collection from such property is complete.[26] The IRS will issue a post-discharge notice to the taxpayer, providing some information as to what debts were dischargeable and payment options for those debts that were not dischargeable, only if it attempts to collect on exempted, excluded, or abandoned property.[27]

IRS Actions with Respect to Taxpayers Who Have Dischargeable Debts and Exempt, Excluded, or Abandoned Assets

The IRS provides inadequate guidance to Insolvency Unit employees trying to collect from the value of exempt, excluded, or abandoned property, which can lead to irrational case decisions. Absent such guidance, some employees seem to have adopted the approach that as long as exempt, excluded, or abandoned assets exist, the IRS will not release the lien without payment even when the property to which the lien attaches is personal property with little or no value and would be exempt from levy under IRC § 6334.[28] Moreover, Field Insolvency employees may determine whether to retain a lien without any managerial review.[29] This lack of managerial oversight may impact the quality of lien retentions. Consider the following example:

Example:

> In one TAS case, **the IRS spent over two years investigating the potential to collect from exempt assets before finally accepting $130 from the taxpayer for the value of her clothing, an old computer, and $20 in cash she had listed on her bankruptcy schedules as exempt property. Only after receiving the $130 did the IRS release the liens.** When TAS inquired about the case on behalf of the taxpayer, Insolvency Unit management insisted there were no legal or procedural errors in this case.[30]

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24 IRM 5.9.17.18 (May 16, 2008); IRM 5.9.17.4.2 (May 16, 2008).

25 IRM 5.9.17.18 (May 16, 2008).

26 *Id.* Before adjustment of a dischargeable tax and release of an NFTL, the following determination must be made: no exempt, excluded, or abandoned assets exist or are not worth pursuing; collection from assets is concluded; future collection potential does not warrant keeping the account in IRS inventory; no pending litigation; no further monitoring required (except for appropriate closing actions); no other pending case actions (for example, no further distributions in the bankruptcy case are anticipated).

27 IRS Notice L4068.

28 IRC § 6334(a). The following items are exempt from levy: (1) wearing apparel and school books; (2) fuel, provisions, furniture, and personal effects; (3) books and tools of a trade, business, or profession; (4) unemployment benefits; (5) undelivered mail; (6) certain annuity and pension payments; (7) workmen's compensation; (8) judgments for support of minor children; (9) minimum exemption for wages, salary, and other income; (10) certain service-connected disability payments; (11) certain public assistance payments; (12) assistance under Job Training Partnership Act; and (13) residences exempt in small deficiency cases and principal residences and certain business assets exempt in absence of certain approval or jeopardy.

29 IRS response to TAS information request (July 23, 2009).

30 The taxpayer signed a written consent authorizing the disclosure of this taxpayer information.

In reviewing current IRM guidance, TAS determined that the Insolvency Unit's conclusion was correct – the IRS does have the authority to pursue a taxpayer for $130 for payment of pre-petition taxes. However, the example vividly demonstrates the need for better guidance for Insolvency Unit employees engaged in this type of work. Discretion and good judgment must be considered when making a determination to pursue these assets, particularly if they are of nominal value or are essential in nature, such as cash and clothing. Managerial oversight of these decisions is an absolute necessity.[31]

Valuation of Assets

IRS guidance directs Insolvency employees to pursue collection of the value of a retirement plan or other assets as they were originally valued on the bankruptcy schedules. However, this approach does not adequately reflect the post-discharge value nor should it determine the amount the IRS can collect on its lien. Property encumbered with a federal tax lien may appreciate or depreciate. The IRS can only collect the current value of the property subject to the lien taking into account any increase or decrease in the value of the property since the date of the bankruptcy filing.[32] Even so, the IRS provides no guidance to its employees on how to value these assets in order to properly calculate the value of the property subject to the lien. As one can imagine, many assets (such as retirement accounts) may have lost substantial value over the past few years due to the economic downturn, so when collecting post-petition, the IRS must be careful to properly calculate the current value of the property subject to the lien. The IRS needs to instruct its employees how to obtain an accurate current value.

In addition, demand letters sent to taxpayers list the entire unpaid tax liability eligible for discharge, even though the IRS is only entitled to collect the value of the exempt, excluded, or abandoned assets, which may be much less than the liability listed on the letters. This is misleading to the taxpayer. For example, if a taxpayer had an asset worth $10,000 prior to bankruptcy, the IRS only has the right to collect $10,000 (assuming it is still worth that much), yet the IRS lists the entire unpaid tax amount on the letter. IRS employees are not provided guidance on the various factors to consider in determining the current value of the IRS lien interest in the property.

IRS Lien Retention Policy Harms Taxpayers Unnecessarily

In 2007, the IRS updated IRM procedures to state that pre-petition NFTLs were not required to be released on discharged tax liabilities and could remain in place indefinitely in certain cases if the taxpayer owned real property.[33] This policy has serious consequences for taxpayers. For example, in cases where all the taxes were discharged and the pre-petition lien is not released, the NFTL remains filed in the public record with the standard language that the lien attaches to all of the taxpayer's property, even though post-discharge,

31 Such assets would be exempt from levy under IRC § 6334.

32 IRM 5.9.17.4.2(2) (May 16, 2008).

33 IRM 5.9.17.4.2 (May 16, 2008).

the lien only attaches to the exempt, abandoned, or excluded property. If the IRS leaves the NFTL on file, it should file an amended notice of lien explaining that the NFTL now only attaches to the exempt, abandoned, or excluded property that existed as of the bankruptcy petition date.[34]

The National Taxpayer Advocate is concerned that the IRS does not track how many liens it leaves in place after a discharge has been granted, and does not periodically review these cases. Nor does it track how many tax liens are later released or how much revenue is collected from leaving these liens on the taxpayers' assets.[35] It is unclear how the IRS can fully assess its approach toward its post-discharge collection decisions when it has not determined whether its actions are yielding the desired results. The inability to fully evaluate this procedure may lead to taxpayers being burdened with liens on their assets until the statutory period for collection expires, while producing little or no revenue for the IRS. Both the IRS and the taxpayer would be better off resolving the tax debt early on, especially when one considers the long-term benefit of bringing a taxpayer into compliance.

Taxpayers Who Have Nondischargeable Tax Debts

When considering the collection potential of post-discharge tax debts, the IRS should place more emphasis on working with the taxpayer rather than automatically pursuing collection from exempt, excluded, or abandoned assets. Moreover, the IRS should use the post-bankruptcy period as an opportunity to bring the taxpayer into compliance and fully address any remaining tax debts and compliance issues. Yet, at this point in the process, the Insolvency Unit does not actively engage in a dialogue with the taxpayer to resolve all remaining issues. Note that in such situations, the taxpayer generally may not be eligible for an offer in compromise (OIC) or an installment agreement (IA) although, as discussed later, other payment arrangements may be available.[36] If nondischargeable tax debts exist after bankruptcy and the taxpayer cannot pay them in full, the case will re-enter the IRS collection stream and be worked like any other, without regard to the taxpayer's recent bankruptcy status. IRS letters sent from this point forward make no mention of the recent bankruptcy, which may be confusing to a taxpayer who is unaware that his or her tax debts survived bankruptcy. Further, by this time the taxpayer's representative in the bankruptcy may no longer be available to explain why the taxpayer still has a liability.[37]

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34 See Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of the Law, Fail to Promote Future Tax Compliance, and Unnecessarily Harm Taxpayers, supra*, for a discussion of other lien issues.

35 IRS response to TAS information request (July 23, 2009).

36 IRC § 6159 indicates that IAs are executed so that a taxpayer may satisfy a "liability," and IRC § 7122 allows for compromises with respect to doubt as to "liability." If the underlying tax is discharged, then there is no "liability," and thus, these provisions do not apply. IRC § 7122 also allows for compromise if there is doubt as to collectibility. Doubt as to collectibility may be difficult to establish in these situations because what can be collected is the value of exempt, abandoned or excluded property. IRC § 7122 also authorizes offers based on effective tax administration. This option may be a possibility if the facts establish grounds for this type of offer. *See* IRS, Chief Counsel Advice 200133044; IRS, Chief Counsel Advice 200248008. Chief Counsel Advice may not be cited as precedent but may provide insight into the how the IRS Office of Chief Counsel is likely to analyze an issue.

37 IRS Pub. 908, *Bankruptcy Tax Guide* (Mar. 2009). This 30-page publication is the only information the IRS currently provides taxpayers on bankruptcy. It would be helpful if taxpayers were given a brochure with the basic information on how bankruptcy impacts taxes.

The IRS could take steps to help taxpayers understand what will happen after bankruptcy and how to resolve their remaining liabilities. For instance, the IRS could send a letter to the taxpayer at the end of the bankruptcy but prior to closing the bankruptcy case and returning it to the collection stream. Rather than being a demand letter, the letter could summarize the result of bankruptcy, list the discharged and nondischarged tax debts, describe what collection actions the IRS might take after bankruptcy, and explain what collection alternatives are available. This letter could clarify in plain language what happened, what is going to happen, and how the taxpayer can resolve the matter. Such a closeout letter would minimize confusion and provide taxpayers with options to resolve the debt. This letter could be similar to the letter that the IRS already sends to taxpayers regarding their dischargeable debts, which is a payment notice.[38] However, a closeout letter could focus more on summarizing the bankruptcy and the next steps.

Sending bankruptcy closeout letters to taxpayers detailing collection alternatives and having one employee work with taxpayers on all their tax debts are just the first steps in resolving taxpayers' problems. After this, the IRS should focus on resolving the liability and bringing the taxpayer into compliance. If the taxpayer's pre-petition tax debts were not discharged or the taxpayer has post-petition debts, the IRS should make every effort to work with the taxpayer in setting up a payment arrangement, such as an OIC or an IA to get him or her back on the right track.[39] Also, the IRS should consider a lien withdrawal if it would facilitate collection.[40] These steps may bring taxpayers who have just emerged from bankruptcy back into the system and send them on the road to voluntary compliance.

Taxpayers Who Have Both Dischargeable and Nondischargeable Tax Debts

When a taxpayer has both dischargeable and nondischargeable tax debts after bankruptcy, an already complicated collection situation becomes even more so because different parts of the IRS work these two types of debts. The Insolvency Unit handles collection of the dischargeable tax by investigating whether to pursue collection from exempt, excluded, or abandoned property, while the nondischargeable debts re-enter the normal collection stream.[41]

The IRS has different enforcement options for the different debts. When a debt is nondischargeable, the taxpayer's personal liability still exists, and the IRS and the taxpayer have a number of collection alternatives (*i.e.*, OICs, IAs, and partial payment installment agreements). Additionally, the IRS is not limited to just foreclosing its lien interest to collect a nondischargeable debt – it can and should use all of its collection enforcement tools. However, if the underlying debt has been discharged, then the taxpayer's personal liability

38 IRS Notice L4068.

39 *See* Most Serious Problem: *The Steady Decline of the IRS Offer in Compromise Program Is Leading to Lost Opportunities for Taxpayers and the IRS Alike, supra*.

40 *See* Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of the Law, Fail to Promote Future Tax Compliance, and Unnecessarily Harm Taxpayers, supra.*

41 IRM 5.9.17.20(2) (May 16, 2008).

no longer exists. Because there is no personal liability, the taxpayer may not be able to enter into an IA or OIC to resolve the *in rem* liability associated with the discharged tax debt, but the taxpayer may pay the debt in a short term deferred payment plan.[42] In such cases, the only collection action available to the IRS is to foreclose its lien interest.[43] However, the taxpayer can resolve his or her tax problem and avoid foreclosure by taking one of the following actions: (1) paying the IRS an amount equal to the value of the exempt, excluded, or abandoned property if its value is less than the amount of the discharged tax, (2) paying the unpaid amount of the discharged liability if the property is worth more than the discharged liability, or (3) entering into a short-term deferred payment plan in an amount equal to the value of the lien on the exempt, excluded, or abandoned property.[44]

In situations where the taxpayer has both dischargeable and nondischargeable tax debts, the IRS should permit its revenue officers to retain control over the nondischargeable debts while investigating collection potential from exempt, abandoned or excluded assets. This arrangement would allow the taxpayer to work with one IRS employee to find a solution to the entire tax matter.[45] This approach, rather than advising the taxpayer to "call another number" to resolve the nondischargeable taxes, would yield better service and a more effective approach to resolving the taxpayer's entire IRS debt.[46] By focusing on collecting from exempt, excluded, or abandoned property separately from nondischargeable or current tax liabilities, the IRS may drive the taxpayer into ongoing noncompliance rather than the fresh start that bankruptcy is supposed to provide. Thus, the IRS should proceed with care in these cases, conduct a diligent, thorough review of each case's facts and circumstances, and discuss collection alternatives with the taxpayer when appropriate.

Educating Taxpayers on the Impact of Bankruptcy on Their Tax Liabilities

The process for filing for bankruptcy is confusing for most taxpayers, including an understanding of bankruptcy's impact on taxes post-discharge. Federal taxes in a bankruptcy setting receive unique and complex treatment that leaves even practicing attorneys perplexed, let alone taxpayers. The IRS takes few steps to educate taxpayers on these issues. It should better educate taxpayers emerging from bankruptcy so that they understand the process and are thus better prepared to deal with their tax issues.[47]

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42 IRC § 6159 indicates that IAs are executed so that a taxpayer may satisfy a "liability", and IRC § 7122 allows for compromises with respect to doubt as to "liability." If the underlying tax is discharged, then the there is no "liability", and thus, these provisions do not apply. IRC § 7122 also allows for compromise if there is doubt as to collectibility. Doubt as to collectibility may be difficult to establish in these situations because what can be collected is the value of exempt, abandoned or excluded property. IRC § 7122 also authorizes offers based on effective tax administration. This option may be a possibility if the facts establish grounds for this type of offer. *See* IRS, Chief Counsel Advice 200133044; IRS, Chief Counsel Advice 200248008. Chief Counsel Advice may not be cited as precedent but may provide insight into the how the IRS Office of Chief Counsel is likely to analyze an issue.

43 IRC § 524(a)(1).

44 IRS Notice L4066, *Final Notice – Notice of Intent to Levy and Notice of Your Right to a Hearing*, *IRS Notice L4067*, *Final Notice of Intent to Levy – Please Respond Immediately*; IRS Notice L4068.

45 Revenue officers could handle cases where the taxpayer has both dischargeable and nondischargeable tax debts if given the proper training.

46 IRS, *2009-2013 Strategic Plan* 14.

47 IRS Pub. 908, *Bankruptcy Tax Guide* (Mar. 2009). This is the only information the IRS currently provides to taxpayers on bankruptcy.

The IRS could develop brochures to inform taxpayers of the general treatment of taxes in a bankruptcy proceeding. The brochures would also help bankruptcy professionals (such as attorneys) inform taxpayers of the impact of bankruptcy on taxes. Additionally, the IRS could work with the U.S. Bankruptcy Courts to include stuffers and brochures in its notices to provide taxpayers with more information on taxes and bankruptcy. The Bankruptcy Act requires taxpayers to enter into credit counseling prior to filing for bankruptcy.[48] This venue may be a good opportunity for counselors to talk with taxpayers about the impact the bankruptcy will have on their tax debts.

The IRS should also develop a brochure that the taxpayer and credit counselor can review together to make sure the taxpayer understands the difference between a dischargeable and nondischargeable debt and what assets are exempt or excluded form the bankruptcy estate. Because taxpayers are not educated on bankruptcy and the tax consequences, they sometimes enter into bankruptcy prematurely and end up with nondischargeable tax debts that could have been dischargeable had they waited a little longer to file their bankruptcy petition.

CONCLUSION

In conclusion, the National Taxpayer Advocate offers these preliminary recommendations:

1. Provide guidance on how IRS employees should proceed when a debt has been discharged but a tax lien remains on the exempt, excluded, or abandoned property.
2. Work with the taxpayer to make sure every possible resolution to his or her tax problem has been explored, rather than taking enforced collection actions whenever legally permitted.
3. Better educate taxpayers on the effect the bankruptcy process will have on the existing tax liabilities. Better educating taxpayers on bankruptcy issues and working with each taxpayer to resolve the tax issues will assist the taxpayer in rebuilding his or her financial life and starting anew.
4. Provide taxpayers the opportunity to work with one IRS employee to resolve both their dischargeable and nondischargeable debts.
5. Track how many liens survive bankruptcy, how many are later released, and how much revenue is collected as a result of leaving these liens on the taxpayers' assets in an effort to determine the effectiveness of its program. Obtaining data is vital to developing an effective collection strategy.
6. Develop a closeout letter to be sent to taxpayers after bankruptcy, providing information on both their dischargeable and nondischargeable debts and how the taxpayer can resolve any lingering tax issues.

[48] 11 U.S.C. § 109(h). "[A]n individual may not be a debtor under this title unless such individual has, during the 180-day period preceding the date of filing of the petition by such individual, received from an approved nonprofit budget and credit counseling agency described in section 111(a) an individual or group briefing."

7. Improve outreach to taxpayers on bankruptcy by including information of taxpayers' tax debts during and after bankruptcy in both the credit counseling information and stuffers to be sent out with the Bankruptcy Court's information.
8. Revise demand letters stating that the IRS is only entitled to collect the current value of the exempt, excluded, or abandoned assets, not the entire unpaid balance of the tax liability that was discharged.

IRS COMMENTS

The IRS agrees that an important element of bankruptcy policy is the "fresh start" afforded individual debtors upon discharge. Federal bankruptcy law embraces the entire field of debtor-creditor relationships to provide a uniform and equitable method to distribute the debtor's assets to creditors. At the same time, it gives the debtor an opportunity to start over with a clean (or at least improved) financial slate.[49] However, this is just one of the competing policies Congress sought to balance when it created the Bankruptcy Code's comprehensive scheme for treatment of debts. The most recognized example of this balance is found in the numerous exceptions to discharge located in § 523 of the Bankruptcy Code. In balancing the fresh start sought by debtors, creditors' interest in collecting, and the general public's interest in having an orderly process to support the flow of commerce, Congress determined that certain debts would not be discharged, even by a debtor who successfully completed the bankruptcy process.[50] Similarly, bankruptcy law has long recognized that a bankruptcy discharge does not generally affect lien interests,[51] and the Supreme Court has affirmed that this rule survives under the current Code.[52]

Collection from exempt, abandoned, or excluded assets is consistent with the policy decisions made by Congress in establishing and defining the scope and limits of the relief afforded to debtors under the Bankruptcy Code. Any collection actions taken to enforce the federal tax lien against assets that were exempt, abandoned, or excluded from the bankruptcy estate must be in accordance with the provisions of the IRC, Treasury Regulations, and IRS policies and procedures.[53] All IRS requirements such as level of approval required, consideration of economic hardship, and use of other collection alternatives, continue to apply to assets that were part of a bankruptcy estate. Specific guidance is provided in the insolvency IRM.[54]

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49 11 U.S.C. § 522.

50 *See Grogan v. Garner*, 498 U.S. 279, 287 (1991) ("Congress evidently concluded that the creditors' interest in recovering full payment debts in these categories outweighed the debtors' interest in a complete fresh start.").

51 *See Long v. Bullard*, 117 U.S. 617 (1886).

52 *See Johnson v. Home State Bank*, 501 U.S. 78 (1991); *Dewsnup v. Timm*, 502 U.S. 410 (1992).

53 IRM 5.9.17.4.1 (May 16, 2008).

54 *See* William D. Elliott, *Federal Tax Collections, Liens and Levies* ¶ 20.03 (2009); IRM 5.9.17.4.3 (May 16, 2008).

The investigation and resolution of post discharge lien interests is the responsibility of the field insolvency units.[55] Employees in these units receive extensive training for making collection determinations regarding exempt, abandoned, or excluded property. Employees receive training on reviewing debtor's bankruptcy schedules, addressing lien issues, determining the market value of assets, and giving consideration to the taxpayers circumstances.[56] Insolvency employees use specific guidance provided in the insolvency IRM for evaluating and making decisions on bankruptcy cases, including situations where a lien is retained on exempt, abandoned, or excluded property after a bankruptcy discharge.[57] This guidance did not come in the form of "sweeping changes", but has been an integral part of insolvency specialist and advisor training material since prior to 2007. Guidance revised in 2007 was not a policy change, but rather an affirmation of established policy.

Only a small percentage, an average of six percent for FY 2008 and 2009, of Chapter 7 no asset cases were reviewed to determine the potential lien interest in exempt, excluded, or abandoned property.[58] This illustrates that the decision to pursue IRS lien interests in these cases is a selective and deliberative process.

Managerial safeguards and controls, including managerial approval of enforcement action taken against assets that were exempt, abandoned, or excluded from the bankruptcy estate, are incorporated into current IRS policies and procedures.[59] Additionally, in FY 2009, we implemented a national quality review of Chapter 7 no asset exempt property investigation cases. The review addresses whether employee actions, such as observance of taxpayer rights, initial analysis, appropriate enforcement actions, financial analysis, problem solving, and analytical skills, were completed in accordance with applicable policies and procedures.

The IRS Letter 4068, *Post-discharge Letter Seeking Payment*, provides notification to the debtor that an investigation is being conducted into the value of any exempt, excluded, or abandoned property. The letter informs the taxpayer that the taxes have received a discharge, but also clearly indicates that a lien remains on exempt, abandoned and excluded assets. The letter provides guidance to the debtor for calculating the current value that the federal tax lien(s) is attached to in the exempt, abandoned, or excluded property. It also encourages the debtor to contact the insolvency employee to resolve the remaining issues.[60] Also available on the IRS website is Publication 908, *Bankruptcy Tax Guide*.[61] This publication covers federal income tax aspects of bankruptcy.

55 IRM 5.9.17.4.2(8) (May 16, 2008).

56 Course #11813, Insolvency New Hire, B-1-19 and Course #16829-002 (10-2006).

57 IRM 5.9.17.4.2(19) (May 16, 2008).

58 CAR C23 Report, September MAAG for Field Insolvency.

59 IRM 5.9.17.4.3(11) (May 16, 2008).

60 Letter 4068 (Rev. Mar. 2006).

61 IRS Pub. 908, *Bankruptcy Tax Guide* (Mar. 2009).

The IRS believes adequate procedural guidance and training are provided for insolvency employees to address situations where a lien remains on exempt, abandoned, or excluded property after a bankruptcy discharge.[62] This guidance addresses equitable settlement of lien interests, taking into account IRS requirements and mitigating factors that should be considered. The IRS believes assigning a single revenue officer to pursue both dischargeable and non dischargeable post bankruptcy tax liabilities would not be in the best interests of the taxpayer or the government. Our practice of using insolvency employees to work dischargeable assessments reduces the potential for violation of a discharge injunction and thus provides protection to the taxpayer.

The National Taxpayer Advocate makes eight preliminary recommendations to improve service to taxpayers and promote compliance following bankruptcy. The IRS is taking or has taken the following actions with respect to these recommendations:

The IRS believes adequate procedural guidance and training is provided for insolvency employees to address situations where a lien remains on exempt, abandoned, or excluded property after a bankruptcy discharge. However, we do agree proper training and guidance for our employees are very important and, as such, continually look at ways to improve.

The IRS works with taxpayers that have post bankruptcy dischargeable taxes to advise them of our lien interest and attempt to reach a mutually acceptable agreement. Enforcement collection actions are infrequent and are only used as a last resort and under very specific circumstances.

The IRS, like the National Taxpayer Advocate, believes that it is important to educate taxpayers on the effect the bankruptcy process will have on the existing tax liability. We believe we achieve this through the current publication and letters available to the taxpayers and their representatives. However, as we continue to strive to improve taxpayer education and outreach, we will explore the feasibility of developing a pamphlet that could be sent out by the Bankruptcy Courts that will further explain the general treatment of taxes in a bankruptcy proceeding.

The recommendation to have a revenue officer pursue both dischargeable and non dischargeable post bankruptcy tax liabilities would not be in the best interests of the taxpayer or the government. Our practice of using insolvency employees to work dischargeable assessments reduces the potential for violation of a discharge injunction and thus provides protection to the taxpayer.

Because every investigation into exempt, abandoned, or excluded assets stands on its individual merits, capturing nationwide data on liens not released or money received could provide misleading data and would not yield supportable conclusions.

[62] IRM 5.9.17.4.2(19) (May 16, 2008).

The Letter 4068 is utilized when there is a need to communicate to the taxpayer that there are remaining issues germane to the bankruptcy filing. A closeout letter would not adequately capture every taxpayer's unique situation and would not be able to be effectively administered.

As explained previously, the IRS agrees it is important to educate taxpayers on bankruptcy. We achieve this through the current publication and letters available to the taxpayers and their representatives. However, as we continue to strive to improve taxpayer education and outreach, we will explore the feasibility of developing a pamphlet that could be sent out by the Bankruptcy Courts that will further explain the general treatment of taxes in a bankruptcy proceeding.

The demand letters are currently under review and the IRS will ensure that any revision clearly states that the IRS is only entitled to collect the current value of the exempt, excluded, or abandoned assets, not the entire unpaid balance of the tax liability that was discharged.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate recognizes that bankruptcy law balances two competing principles: taxpayers' obligation to pay taxes and debtors' need for a fresh start. Further, the National Taxpayer Advocate does not dispute the IRS's legal authority to enforce prepetition liens on taxpayers' exempt, excluded, or abandoned assets after bankruptcy,[63] but rather, is urging the IRS to focus on working with taxpayers to resolve their problems and avoid having to pursue enforcement of its lien interest.

Provide Additional Guidance to Employees

The National Taxpayer Advocate also recognizes that IRS employees work hard to navigate the complicated intersection of tax and bankruptcy law. We commend the IRS for conducting national quality reviews and analyzing whether employees' actions (such as observance of taxpayer rights, initial analysis, appropriate enforcement actions, financial analysis, problem solving, and analytical skills) were completed in accordance with policies and procedures in Chapter 7 no asset exempt property investigation cases. However, the IRS should provide its employees the guidance necessary for them to do their jobs effectively. Such guidance should direct employees not to pursue assets of nominal value. Current IRM procedures are insufficient because they contain little or no instruction on how to value retirement accounts or other exempt, excluded, or abandoned assets post-discharge.

63 *Johnson v. Home State Bank*, 501 U.S. 78 (1991).

Require Managerial Review Before Liens Are Retained Post-Discharge

The National Taxpayer Advocate is troubled by the new policy of permitting pre-petition NFTLs to remain on file (sometimes indefinitely if the taxpayer owned real property) when all the underlying taxes have been discharged.[64] This policy is different than the one expressed in a prior version of the IRM, which instructed employees to release the NFTLs if no action was being taken with respect to exempt, abandoned, or excluded property.[65] Previously, the IRS based this decision more upon the current value of the asset in question. However, current guidance places a heightened emphasis for lien retention based on future collection potential, even though no immediate collection activity is planned.[66] Most disturbing is that the Insolvency employee's determination is done without any managerial oversight and the IRS does not revisit or track the lien unless the taxpayer submits full payment or requests another type of lien certificate (*e.g.*, discharge, subordination, or withdrawal), or the statutory period of limitations for collection action expires.

Given that the IRS requires managerial review prior to levying on exempt, abandoned, or excluded assets[67] and now requires managerial approval for *not* filing a lien on collection cases, the National Taxpayer Advocate believes managerial approval should also be required for the important decision of whether to retain a lien. Managers have insight and can exercise good judgment when determining whether to pursue certain assets.[68] Moreover, the IRS should implement a tracking mechanism for liens that are retained after discharge. To allow a lien to indefinitely remain on file, based on a subjective determination that has no checks or balances, can needlessly harm a taxpayer's ability to make a fresh start outside of bankruptcy.

Conduct Cost/Benefit Analysis of Lien Filings

The IRS states that it reviewed only six percent of Chapter 7 "no asset" cases for FY 2008 and FY 2009 to determine the potential lien interest in exempt, excluded, or abandoned property.[69] Thus, 24,000 taxpayers may have had liens retained on their exempt, excluded, or abandoned assets.[70] We do not know what happened to these 24,000 taxpayers because the IRS does not track this information.[71] The National Taxpayer Advocate disagrees that tracking would not provide the IRS with useful information. Tracking will help the IRS critique its current policies and could provide data useful for cost and benefit analysis. Lien filings impose a significant burden on taxpayers, yet IRS does not know whether such filings yield any benefit.

64 IRM 5.9.17.4.2 (2007).

65 IRM 5.9.17.4.1(7) (Aug. 1, 2005).

66 IRM 5.9.27.4.2 (May 16, 2008).

67 IRM 5.9.17.4.3(11) (May 16, 2008).

68 IRS response to TAS information request (July 23, 2009).

69 IRS, Collection Activity Report NO-5000-C23, *Collection Workload Indicators Reports* (Oct. 13, 2009).

70 IRS response to TAS information request (Nov. 19, 2009).

71 IRS response to TAS information request (July 23, 2009).

Improve Communication with Taxpayers Coming out of Bankruptcy

The National Taxpayer Advocate acknowledges that the IRS sends taxpayers a letter seeking payment regarding their dischargeable debts.[72] However, this is more akin to a demand for payment letter. This letter does not achieve the approach the National Taxpayer Advocate encourages the IRS to adopt, namely working with taxpayers to become and remain compliant after bankruptcy. Such a letter should summarize the result of bankruptcy, list the discharged and nondischarged tax debts, describe the post-bankruptcy collection actions the IRS might take, and explain what collection alternatives are available.

Enable Taxpayers to Work with One IRS Employee to Resolve Nondischargeable and Dischargeable Debts Post-Bankruptcy

The National Taxpayer Advocate does not understand why assigning the same revenue officer to work with the taxpayer to resolve both nondischargeable and dischargeable debts would not be in the best interest of either the taxpayer or the government. In fact, this approach would appear to benefit both parties. The taxpayer could work with one IRS employee rather than several, while the revenue officer could analyze the entire situation in context rather than looking only at a small part of the taxpayer's case and possibly missing an important aspect of the case. The IRS suggested that having Insolvency employees work dischargeable assessments reduces the potential for violation of a discharge injunction and thus offers protection to the taxpayer. However, the National Taxpayer Advocate does not understand why, if given the appropriate training, the revenue officer could not provide the same protection. Alternatively, since very few cases are involved, Insolvency employees could work cases involving both nondischargeable and dischargeable debts.

Work with TAS to Develop Language for Brochure on Tax Issues in Bankruptcy

Finally, we are pleased that the IRS is exploring the feasibility of developing a brochure explaining the general treatment of taxes in bankruptcy proceedings to be included as a stuffer by the Bankruptcy Courts. We would be happy to work with the IRS in developing easy-to-read language for such a brochure.

[72] IRS Notice L4068.

Recommendations

The National Taxpayer Advocate offers these specific recommendations:

1. Develop and implement explicit guidance requiring managerial approval of all post-discharge lien retention determinations.
2. Track how many liens survive bankruptcy, how many are later released, and how much revenue is collected as a result of leaving these liens on the taxpayers' assets, and use this data to analyze the effectiveness of the program.
3. Permit revenue officers to retain control over nondischargeable debts while investigating collection potential from exempt, abandoned or excluded assets.
4. Work with the U.S. Bankruptcy Courts to include stuffers to be sent out with notices that contain information on tax debts during and after bankruptcy.
5. Revise demand letters to provide taxpayers with information on both their dischargeable and nondischargeable debts, state that the IRS is only entitled to collect the current value of the exempt, excluded, or abandoned assets, not the entire unpaid balance of the tax liability that was discharged, and explain how the taxpayer can resolve any lingering tax issues.

MSP #17

Ponzi Schemes Present Challenges for Taxpayers and the IRS

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Definition of Problem

An embezzler may use a "Ponzi" scheme to steal from a large number of "investors."[1] The embezzler maintains the illusion that the scheme is a valid investment by using funds from new investors to finance payments to existing investors.

The number of known Ponzi victims increased significantly in late 2008 and in 2009. As of June 2009, the FBI had almost 500 open Ponzi investigations nationwide – up from about 300 in 2006.[2] The Securities and Exchange Commission (SEC) reportedly filed at least 23 new cases against Ponzi operators in 2008, up from 15 in 2007.[3] The infamous Madoff Ponzi scheme – the largest ever, apparently involving over $50 billion and 15,400 investors – came to light in late 2008.[4] By comparison, taxpayers claimed less than $3 billion in casualty and theft losses (*i.e.*, "theft loss claims") on returns in tax year 2007.[5] Thus, a single scheme has the potential to increase the dollar amount of theft loss claims more than 15-fold.

Ponzi schemes create problems for both taxpayers and the IRS. When Ponzi victims learn that previously-reported investment income does not actually exist and they have lost much or all of their initial investment, they face a number of tax-related questions. Tax-exempt victims may also face tax reporting and compliance questions.

1 Charles Ponzi duped thousands into investing in a postage stamp speculation scheme back in the 1920s. Ponzi said he could provide a 40 percent return in just 90 days, and was deluged with funds from investors. He paid returns to early investors to make the scheme look legitimate before it ultimately collapsed. Schemes using similar "rob-Peter-to-pay-Paul" principles are often called "Ponzi" schemes. *See* SEC, *"Ponzi" Schemes* (Apr. 19, 2001), http://www.sec.gov/answers/ponzi.htm. For an interesting discussion about Ponzi schemes, see Ron Chernow, *Annals of Finance, Madoff and His Models*, The New Yorker, Mar. 23, 2009, at 28-33.

2 Del Quentin Wilber, *Economic Downturn Accelerates Collapse of Ponzi Schemes*, Washington Post, June 12, 2009.

3 Mitchell Zuckoff, *A Parade of Ponzis*, Fortune (Jan. 28, 2009), http://money.cnn.com/2009/01/28/news/newsmakers/Ponzis.fortune/index.htm.

4 *See, e.g.*, Criminal Complaint ¶4(d), *United States v. Bernard L. Madoff* (filed Dec. 11, 2008), http://www.usdoj.gov/usao/nys/madoff/criminalcomplaint.pdf; Transcript of Guilty Plea Proceeding at 34, *United States v. Bernard L. Madoff*, 09 CR 213 (S.D.N.Y., recorded Mar. 12, 2009), http://www.usdoj.gov/usao/nys/madoff/madoffhearing031209.pdf; Baker & Hostetler LLP, Adv. Pro. No. 08-1789, *Trustee's First Interim Report*, Dec. 11, 2008 - June 30, 2009, 2 n. 2 (July 9, 2009) (reporting the receipt of over 15,400 customer claims). Madoff was ultimately sentenced to 150 years in prison. *Id.* at 5.

5 IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2007).

The primary challenge for the IRS is to assist these victims in answering their questions before they take improper tax positions, which may drain IRS resources available to address other tax compliance problems. Another challenge is to timely and consistently process the inevitable influx of amended returns, theft loss claims, and claims for refund relating to the schemes, without paying refunds (or allowing deductions) to taxpayers who are not entitled to them.[6]

ANALYSIS OF PROBLEM

Background

Prior to Madoff, the rules governing the tax treatment of Ponzi losses were unclear.

When Ponzi victims learn they have lost most or all of their investment, they face a number of tax-related questions such as whether, when, and how to report their losses and reverse the so-called "phantom income" – income they reported and paid taxes on in prior years, but never received because it was supposedly reinvested. In early 2009, as victims of the Madoff scheme began asking questions about the tax implications of their losses, basic questions remained unsettled, such as:

- Whether taxpayers could file amended returns to eliminate phantom income reported on returns for which the statute of limitation period remained open;[7]
- Whether theft loss deductions would be subject to a floor;[8] and
- Whether a taxpayer could claim that phantom income, which never existed, had been stolen.[9]

Articles in the press highlighted the confusion taxpayers faced in applying these rules.[10]

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6 For a discussion of problems associated with amended returns, see, *e.g.*, National Taxpayer Advocate 2008 Annual Report to Congress 274.

7 Some authority suggests taxpayers can amend returns to eliminate phantom income and treat actual distributions as a return of capital. *See Greenberg v. Comm'r*, T.C. Memo. 1996-281; *Kooyers et ux., et al. v. Comm'r*, T.C. Memo. 2004-281; *Johnson v. United States*, 79 Fed. Cl. 266 (2007); *Taylor v. United States*, 81 A.F.T.R.2d 98-1683, 98-1 U.S.T.C. ¶ 50,354 (E.D. Tenn. 1998). However, IRS attorneys seem to disagree. *See, e.g.*, CCA 200451030 (Dec. 17, 2004); CCA 200811016 (Mar. 14, 2008). According to recent guidance, however, investors may amend returns to eliminate phantom income in some circumstances. *See* Rev. Proc. 2009-20, 2009-14 I.R.B. 749 § 8.02.

8 The IRS's former official position was that Ponzi losses were subject to the floor. Rev. Rul. 71-381, 1971-2 C.B. 126. As the IRS more recently clarified, this official position was obsolete. *See* Rev. Rul. 2009-9, 2009-14 I.R.B. 735.

9 Some authority suggests that a taxpayer may not take a theft loss with respect to phantom income because it never existed. *See Kaplan v. United States*, 100 A.F.T.R.2d 2007-5674, 2008-1 U.S.T.C. ¶ 50,117 (M.D. Fla. 2007). To the extent the phantom income is taxable it may increase the victim's basis in his or her principal investment, which he or she may, nonetheless, be able to claim as a deduction. *See* Treas. Reg. §§ 1.165-7(b)(1), -7(a)(6), -8(c). *See also* Rev. Rul. 2009-9, 2009-14 I.R.B. 735.

10 *See, e.g.*, Diane Freda, *Tax Fraud: Tax Recoveries Best Way to Recoup Losses for Madoff Scam Victims, Practitioner Says*, 018 DTR G-2, 2009 (Jan. 30, 2009) (citing one practitioner as stating, for example, that "contrary to numerous newspaper articles, there is no ten percent of income floor on the theft loss relating to those investments.").

The theft loss deduction rules require difficult factual inquiries.

A taxpayer cannot deduct a theft loss until there is no reasonable prospect of recovery.[11] This is a subjective and fact-specific inquiry.[12] Ponzi victims who feel they have lost money want to deduct losses when the scheme is uncovered. However, they may have insurance, the prospect of recovering something in a bankruptcy, or other claims that make it difficult for them to conclude they have no reasonable prospect of recovery, thus delaying their deduction. This fact intensive analysis had the potential to drain both IRS and taxpayer resources.[13] Practitioners, legislators, and the National Taxpayer Advocate called on the IRS to clarify the rules, reduce these burdens, and prevent unnecessary controversies.[14]

The IRS response to the Ponzi problem

The IRS took a number of helpful steps to address the Ponzi problem. On February 13, 2009, the IRS formed a servicewide steering committee, which included a TAS representative, to address Ponzi issues.[15] As of this writing, the committee's working group was considering a number of interesting recommendations, including recommendations to provide additional guidance to indirect investors, IRS employees, receivers administering Ponzi bankruptcies, and revisions to information returns (*i.e.*, Form 1099) that would identify certain Ponzi-related recoveries.[16] The Office of Chief Counsel worked with Treasury, TAS, and the IRS to draft Revenue Ruling 2009-9, which addressed pressing Ponzi-related legal questions.[17] Counsel worked with these same stakeholders on Revenue Procedure 2009-20, which established a safe harbor reporting position allowing some Ponzi victims to take a deduction in the year they discover losses without extensive fact-finding, even if they may

11 *See* Treas. Reg. §§ 1.165-1(d), -8(a)(2). When it can be determined that a portion of the loss will not be recovered or reimbursed, however, that portion can be claimed as a deduction. *Id.*

12 The determination as to when no reasonable prospect of recovery remains is made only by use of foresight, based on facts whose existence was reasonably foreseeable as of the close of year. *Ramsay Scarlett & Co. v. Comm'r*, 61 T.C. 795 (1974), *aff'd*, 521 F.2d 786 (4th Cir. 1975). The determination is primarily objective, but the taxpayer's subjective beliefs are also relevant. *Id.* at 788. Even if a taxpayer has no prospect of recovery except through the Ponzi's bankruptcy proceeding, the bankruptcy trustee's estimate of a recovery percentage may not be sufficient to allow the taxpayer to claim the loss. *See Kaplan v. United States*, 100 A.F.T.R.2d 2007-5674, 2008-1 U.S.T.C. ¶ 50,117 (M.D. Fla. 2007).

13 Prepared Testimony of Douglas Shulman, Commissioner of Internal Revenue, before the Senate Finance Committee Tax Issues Related to Ponzi Schemes and an Update on Offshore Tax Evasion Legislation (Mar. 17, 2009), http://finance.senate.gov/sitepages/hearing031709.htm.

14 *See, e.g.*, George E. Pataki, *Former N.Y. Governor Seeks Meeting with Treasury on Potential for Madoff Investors to Claim Fraud Losses*, 2009 TNT 12-24 (Jan. 12, 2009); Thomas Jaworski, *Senator Calls for Special IRS Unit to Assist Madoff Scandal Victims*, 122 Tax Notes 603 (Feb. 2, 2009); Robert Gordon, *Individual Calls for Immediate IRS Guidance for Investors Caught in Madoff Scheme*, 2009 TNT 30-18 (Feb. 18, 2009); Gary L. Ackerman, *Ackerman Calls on IRS Commissioner to Provide Tax Relief for Victims of Bernard Madoff* (Feb. 25, 2009), http://www.house.gov/apps/list/press/ny05_ackerman/PR_022509a.html; Jeremiah Coder, *IRS Action on Ponzi Scheme Guidance in Doubt*, 122 Tax Notes 1071 (Mar. 2, 2009); *Schumer, Cantwell, Menendez Call for First Congressional Hearings into Ways Victims of Ponzi Schemes Can Be Helped* (Mar. 4, 2009), http://schumer.senate.gov/new_website/record.cfm?id=309091&. The National Taxpayer Advocate and her staff called for guidance internally. E-mail from the National Taxpayer Advocate's staff to IRS (Jan. 7, 2009). The IRS also recorded a request for guidance on its Issue Management Resolution System (IMRS). IMRS 09-0001039, *Ponzi – Outreach Request* (Jan. 7, 2009).

15 IRS response to TAS information request (May 11, 2009).

16 Ponzi Schemes Working Group Final Report as of September 9, 2009.

17 Rev. Rul. 2009-9, 2009-14 I.R.B. 735.

later recover some portion of the losses.[18] The IRS highlighted this guidance on its website and in an e-newsletter to tax professionals.[19]

In addition, IRS campuses temporarily stopped issuing refunds attributable to Madoff Ponzi losses to give taxpayers the option of using the safe harbor that would ultimately be adopted, and to allow IRS employees time to evaluate the claims in light of the forthcoming guidance.[20] The IRS sent letters to taxpayers, who were claiming Ponzi losses on 2008 returns or amended prior-year returns filed before Revenue Procedure 2009-20 was issued, to ask if these taxpayers would rather take advantage of the new safe harbor.[21] The National Taxpayer Advocate also began allowing Ponzi victims to receive assistance from TAS even if their tax problems would not otherwise make them eligible for help.[22]

Continuing challenges for the IRS and taxpayers

The IRS could not consult with as many stakeholders or address as many issues in connection with its Ponzi guidance as it normally would because it was working to quickly finalize the guidance before the filing season. This speed was laudable, but created a number of ongoing challenges. Because the IRS did not tell taxpayers it was working on guidance, it did not receive as much assistance from external stakeholders as usual.[23] Callers inquiring about Madoff-related issues were initially told only: "We are aware of the Madoff issues and are considering the appropriate tax treatment. Unfortunately we do not have any further guidance at this time."[24] Taxpayers expressed frustration at the IRS's initial seeming lack of responsiveness.[25] In addition, some legal questions remain unaddressed.[26]

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18 Rev. Proc. 2009-20, 2009-14 I.R.B. 749. In general, this safe harbor allows "qualified investors" to deduct 95 percent or 75 percent of their "qualified loss," depending on whether they are pursuing any potential third-party recovery, minus any actual recovery and any potential insurance or SIPC recovery. *Id.* at § 5.02. The safe harbor only applies to losses discovered in years beginning after December 31, 2007. *Id.* at § 7.

19 *See* IRS, *Ponzi Scheme Questions and Answers* (Apr. 8, 2009), http://www.irs.gov/newsroom/article/0,,id=206013,00.html; IRS, *Help for Victims of Ponzi Investment Schemes* (Apr. 3, 2009), http://www.irs.gov/newsroom/article/0,,id=205505,00.html?portlet=7; IRS, *e-file for Large and Mid-Size Corporations, Reporting Losses Resulting from Ponzi Schemes* (Apr. 14, 2009), http://www.irs.gov/businesses/corporations/article/0,,id=146959,00.html; IRS, e-News for Tax Professionals, 2009-12, *Technical Guidance* (e-mailed on Mar. 23, 2009).

20 Servicewide Electronic Research Program (SERP) Alert 090023, *Madoff claims - Theft Loss Deduction under IRC 165(c)(2)* (Jan. 14, 2009); SERP Alert 090180, *Interim Procedures – Carryback Claims Associated with Amended Returns Filed for Madoff & Other Ponzi Schemes* (Mar. 31, 2009).

21 IRS response to TAS information request (May 11, 2009). The IRS had received more than 1,300 returns claiming losses from the Madoff Ponzi scheme before it issued Rev. Proc. 2009-20. *Id.*

22 National Taxpayer Advocate, TAS-13.1.7-0309-003, *Guidance on Coding Failed Investment Scheme Claim Cases and Other Criteria 9 Issues* (Mar. 19, 2009).

23 According to press accounts, when asked about theft loss guidance for Ponzi victims, the IRS had no comment. Ryan J. Donmoyer, *Madoff's Victims May Recover Some Losses Through U.S. Tax Code*, Bloomberg (Dec. 18, 2008); Jeremiah Coder, *IRS Action on Ponzi Scheme Guidance in Doubt*, 122 Tax Notes 1071 (Mar. 2, 2009).

24 SERP Alert 090097, *Madoff Claims – Update* (Feb. 19, 2009).

25 *See, e.g.*, Jeremiah Coder, *IRS Action on Ponzi Scheme Guidance in Doubt*, 122 Tax Notes 1071 (Mar. 2, 2009). The National Taxpayer Advocate also received inquires.

26 IRS Chief Counsel employees have been responding to some questions via e-mail. *See, e.g.*, ECC 200903231207535, 2009 TNT 78-50 (Mar. 23, 2009); ECC 200917032, 2009 TNT 78-49 (Mar. 24, 2009).

Some legal questions remain unanswered.

Losses by Indirect Investors

The IRS did not provide guidance or a safe harbor for "indirect" investors.[27] A taxpayer who invested indirectly through a partnership can claim a flow-through deduction pursuant to the safe harbor only if the partnership claims the safe harbor, but the IRS's revenue ruling and revenue procedure did not otherwise address loss reporting by indirect investors.[28] As one example, a person who invested through a retirement account is ineligible for the safe harbor.[29] Another example is a person who invested through a trust.[30] Other indirect investors include those who invested with an advisor who then put the funds into a Ponzi scheme without authorization, or persons who invested with a partnership that learned of the fraud before its investors or the public at large. In each case, these victims are not eligible for the safe harbor and the IRS guidance does not otherwise address these situations.

When to Amend Prior-Year Returns to Eliminate Phantom Income

The IRS did not clarify the circumstances under which taxpayers are entitled to amend prior returns to eliminate phantom income if they do not participate in the safe harbor. Some case law suggests taxpayers may amend prior year returns to eliminate phantom income if it was not actually or "constructively" received, or if it was more properly treated as a return of capital.[31] Revenue Procedure 2009-20 warns that to exclude such income the taxpayer must "establish that amounts sought to be excluded in fact were not income that was ... constructively received," but provides no guidance on how taxpayers may do so.[32] While some case law suggests a relatively minor limitation on the use of earned income may be sufficient to forestall constructive receipt,[33] IRS attorneys recently took the position that Ponzi victims could not amend prior year returns to eliminate phantom income

27 Jeremiah Coder and Sam Young, *Surprise Guidance on Losses for Madoff Victims Draws Mixed Review from Practitioners*, 2009 TNT 50-1 (Mar. 18, 2009) (reporting: "Among the practitioners who reacted skeptically was Michael Kosnitzky ... who ... noted that indirect investors are not protected by it [the IRS safe harbor]. More blunt in his criticism was accountant Richard Oppenheim, who prepared tax returns for Madoff investors from his office in Holmdel, N.J. Taxpayers whose IRAs or section 401(k) plans invested with Madoff are '[expletive deleted],' he said.").

28 Rev. Proc. 2009-20, 2009-14 I.R.B. 749 § 4.03.

29 This aspect of the guidance received criticism in the press. *See, e.g.*, Andrea Coombes, MarketWatch, *Tax Break on Retirement-Plan Losses? Not Likely Rule That Lets Madoff Victims Take Deduction Won't Apply to Most IRA Savers* (Mar. 19, 2009). Taxpayers who invest through IRAs would generally have to liquidate their retirement accounts to take any loss deduction, regardless of whether the loss arises from a Ponzi scheme, other theft, or an investment loss. *See* Notice 89-25, 1989-1 C.B. 662 Q&A-7; IRS, Publication 590, *Individual Retirement Arrangements (IRAs)*, 42 and 70 (Jan. 30, 2009).

30 The IRS has placed some information pertaining to trusts on its website. *See* IRS, *Ponzi Scheme Questions and Answers* (Apr. 8, 2009), http://www.irs.gov/newsroom/article/0,,id=206013,00.html.

31 For cash method taxpayers, an item is "constructively received" and included in a taxpayer's income in the year in which it is credited to the taxpayer's account, set apart for him, or otherwise made available so that he may draw upon it at any time, even if not actually received. Treas. Reg. § 1.451-2. Income is not constructively received if the taxpayer's control of its receipt is "subject to substantial limitations or restrictions." *Id.* Even if amounts are actually or constructively received from a Ponzi scheme, however, under certain circumstances actual or constructive distributions could be treated as a return of capital. *See Greenberg v. Comm'r*, T.C. Memo. 1996-281; *Kooyers et ux., et al. v. Comm'r*, T.C. Memo. 2004-281; *Johnson v. United States*, 79 Fed. Cl. 266 (2007); *Taylor v. United States*, 81 A.F.T.R.2d 98-1683, 98-1 U.S.T.C. ¶ 50,354 (E.D. Tenn. 1998).

32 Rev. Proc. 2009-20, 2009-14 I.R.B. 749 § 8.02.

33 *See e.g., Johnson v. Comm'r*, 25 T.C. 499 (1955); *Huber v. Comm'r*, 12 B.T.A. 1 (1928); *Robinson v. Comm'r*, 44 T.C. 20 (1965); Rev. Rul. 80-300, 1980-2 C.B. 165, *amplified by* Rev. Rul. 82- 121, 1982-1 C.B. 79.

because such positions were inconsistent with the theft loss regime.[34] Moreover, neither Revenue Ruling 2009-9 nor Revenue Procedure 2009-20 addresses when an actual or constructive Ponzi distribution should be recharacterized as a return of capital. Thus, the IRS's recent guidance leaves basic questions unanswered for Ponzi victims who do not or cannot take advantage of the safe harbor.

How to Report Any Clawbacks

Ponzi investors may also be subject to a "clawback" of actual distributions they received pursuant to the Ponzi's bankruptcy proceeding.[35] These investors will have questions about how to treat such clawbacks for tax purposes. Questions remain about whether a victim who is required to return funds pursuant to a bankruptcy clawback or similar rule can take a deduction or otherwise recover his or her losses of investment income under IRC § 1341 or the common law claim of right doctrine.[36] Victims have also asked about the circumstances in which taxpayers who agreed to conditions set forth in Revenue Procedure 2009-20, including "[N]ot to apply the alternative computation in § 1341 with respect to the theft loss deduction allowed by this revenue procedure" would nonetheless be entitled to claim the benefit of those provisions.[37]

Questions Facing Private Foundations

According to press accounts, the Madoff Ponzi scheme involved hundreds of tax exempt entities, such as private foundations, some of which suffered such significant losses that they had to cease operations.[38] Although these entities generally do not file income tax returns upon which they could claim theft losses, private foundations with Ponzi losses face many difficult reporting and compliance issues for which there is little or no precedent or guidance.[39] The IRS's Ponzi guidance does not directly address the issues facing private foundations.

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34 *See, e.g.*, CCA 200451030 (Sept. 2004); CCA 200811016 (June 2007).

35 A bankruptcy trustee may seek to recover or "clawback" payments made by the bankrupt person before the bankruptcy filing. *See, e.g.*, 11 U.S.C § 547. In this way, clawbacks avoid preferences of certain creditors and make more resources available to other creditors. The bankruptcy trustee in the Madoff case may seek clawbacks of payments going back as far as six years under New York law. *See Guidance on the Trustee's Pursuit of Avoidance Recoveries*, http://www.madoff-help.com/wp-content/uploads/2009/05/picard_guidance_avoidance.pdf (last visited Oct. 22, 2009).

36 If an item was included in taxable income for a prior year because it appeared the taxpayer had an unrestricted right to it (*i.e.*, held under a claim of right), and the taxpayer establishes in a later year that he or she did not have an unrestricted right to it, IRC § 1341 generally provides that the taxpayer is entitled to a deduction (or comparable decrease in tax liability) in the later taxable year.

37 Rev. Proc. 2009-20, 2009-14 I.R.B. 749 § 6.02(3).

38 *See, e.g.*, Bill Hutchinson, *Charities Burned by Bernard Madoff and Ponzi Scheme May Have to Close*, Daily News (Dec., 21 2008). *See also* Eleanor Laise and Dennis K. Berman, *Impact on Jewish Charities Is Catastrophic*, WSJ.com, A20 (Dec. 16, 2008).

39 For a more detailed summary of these unanswered questions, see New York State Bar Association Tax Section, Report No. 1183, *Report on Private Foundation Investors in Ponzi Schemes* (May 7, 2009), *reprinted* as, *NYSBA Members Suggest Guidance for Private Foundation Investors in Ponzi Schemes*, 2009 TNT 87-19 (May 8, 2009) (hereinafter, "NYSBA Report").

Private foundations are subject to a two percent tax on "net investment income."[40] Foundations that paid tax on phantom investment income may have questions about whether and how they can recover these payments.[41]

Private foundations also are subject to tax on the failure to make certain minimum distributions each year based on the fair market value of their assets.[42] These requirements present valuation issues for Ponzi scheme investments.[43] Should private foundations treat these investments as having full value until the month or year the loss is discovered? Or can they amend returns for years prior to the discovery of the loss to revalue their Ponzi scheme investments and carry forward any excess qualifying distributions that may result from such revaluation?[44] Should the possibility of recovery be treated as an asset and valued? If so, how? Does it make a difference if a foundation is a direct or indirect investor in the Ponzi?

In addition, private foundations and their managers are subject to an excise tax on investment that "jeopardizes" the foundation's charitable purpose, *i.e.*, managers failed to exercise ordinary business care and prudence in making investment decisions.[45] These taxpayers have questions about what level of diligence managers are required to exercise in avoiding the tax and when the IRS would seek to assess it.[46] Does it matter if the foundation is a direct or indirect investor? When might placing a substantial portion or all of a foundation's assets with one fund manager be enough to trigger the tax, even if the manager represents that the investments are diversified?[47]

Some taxpayers requested expedited refunds and examinations.

The number of returns claiming theft losses and refunds may also present challenges for the IRS. As noted above, the IRS temporarily stopped issuing refunds in the period before issuing Ponzi guidance and, in many cases, examined returns claiming large losses. Refund processing delays can obviously create financial hardships for taxpayers who have lost everything. While the IRS has little data regarding processing delays experienced by Ponzi victims, most Ponzi victims who have sought assistance from TAS are requesting expedited

40 *See* IRC § 4940.

41 Diane Freda, *Tax Fraud: Tax Recoveries Best Way to Recoup Losses for Madoff Scam Victims, Practitioner Says*, 018 DTR G-2, 2009 (Jan. 30, 2009) (citing one practitioner as suggesting private foundations could amend returns to obtain a refund for the tax).

42 IRC § 4942.

43 The same valuation questions may arise in connection with taxpayers who paid estate or gift taxes on assets "invested" with a Ponzi scheme.

44 *See* Treas. Reg. § 53.4942(a)-3(e) (carryover of excess qualifying distributions). Certain retirement vehicles are similarly required to distribute a certain percentage of their assets each year, potentially raising similar questions. *See, e.g.*, IRC § 401(a)(9).

45 IRC § 4944; Treas. Reg. § 53.4944-1 *et. seq.*

46 *See* Lynnley Browning, *For Investing with Madoff, Private Foundations Could Face U.S. Tax Fines*, International Herald Tribune (Feb. 12, 2009); *Schumer, Cantwell, Menendez Call for First Congressional Hearings Into Ways Victims of Ponzi Schemes Can Be Helped* (Mar. 4, 2009), http://schumer.senate.gov/new_website/record.cfm?id=309091& ("The Madoff scheme has impacted more than 150 private foundations. It is unclear whether these foundations will be forced to pay onerous excise taxes as a result of the fraud."); Statement of William Josephson, Esq., Before the Committee on Finance (Mar. 17, 2009), http://finance.senate.gov/sitepages/hearing031709.htm ("no one really knows what Code section 4944 really means").

47 NYSBA Report 16, n.38 (citing others who have raised this question, and noting that examples in the regulations are "outdated").

processing of refund requests or an expedited examination process.[48] For example, minor delays resulted when IRS field personnel would not release refunds before receiving guidance about what documentation would be needed. These delays were exacerbated by IRS concerns about issuing erroneous refunds. TAS has been working cooperatively with the IRS to assist taxpayers in these matters.

CONCLUSION

The IRS has generally addressed the marked increase in Ponzi schemes very well. It issued helpful guidance in response to calls by well-connected victims of the Madoff scheme. However, this guidance does not answer all of the Ponzi-related tax questions. Less noteworthy Ponzi schemes surface on a regular basis. Without additional guidance, victims of these schemes will continue to face complicated Ponzi-related tax questions at a time when they can least afford expensive tax advice. Answering Ponzi-related questions one at a time is not the best approach for the IRS to pursue for the long term. Thus, the IRS should seize this opportunity to clear up the remaining confusion about Ponzi-related tax issues.

In conclusion, the National Taxpayer Advocate offers the following preliminary recommendations:

1. Publish additional guidance, or at least provide answers to more of the most frequently asked questions; and
2. Consider the Ponzi Schemes Working Group's recommendations, particularly those identifying the need for additional guidance and changes to Form 1099 (described above).

IRS COMMENTS

We agree with the National Taxpayer Advocate that the tax administration matters emanating from Ponzi schemes are complex, affect a myriad of taxpayers, and require the IRS to consider various options to effectively administer such matters. As the National Taxpayer Advocate mentions, the IRS responded quickly to the increase in concerns related to Ponzi schemes by providing helpful guidance to taxpayers and by forming a servicewide steering committee and a Ponzi Scheme Working Group to address Ponzi-related matters. The Ponzi Scheme Working Group recently prepared recommendations for addressing various Ponzi-related matters. These recommendations are being considered by the appropriate individuals in the impacted Business Operating Divisions.

To assist taxpayers who were negatively impacted by Ponzi schemes, the IRS initially issued two guidance items, Revenue Ruling 2009-9 and Revenue Procedure 2009-20. Rev. Rul. 2009-9 clarifies the income tax law governing losses from such schemes. Rev. Proc. 2009-20 provides an optional safe-harbor method of computing and reporting the losses

[48] Taxpayer Advocate Management Information System (TAMIS) query (Apr. 2009); IRS response to information request (May 11, 2009).

and clarifies that taxpayers who choose not to use the optional method may file amended returns. These guidance items address the principal and most immediate issues of broad applicability to the majority of affected taxpayers. The guidance makes it easier for taxpayers to determine the correct tax deductions resulting from their Ponzi scheme losses and provides certainty as to the correct taxable years in which such losses can be claimed. The guidance also facilitates the IRS's processing of affected tax returns.

Since issuing Rev. Rul. 2009-9 and Rev. Proc. 2009-20, the IRS has continued to answer questions related to Ponzi schemes. For example, the IRS has posted on www.irs.gov frequently asked questions on the treatment of indirect investments in Ponzi schemes through partnerships and trusts. Advice has also been provided in the form of general information letters responding to inquiries from taxpayers through their members of Congress, informal advice in telephone inquiries from taxpayers and tax professionals, and advice to IRS personnel on cases in various stages of development that involve Ponzi scheme losses.

However, the National Taxpayer Advocate's report notes that the guidance the Service has provided to date does not answer all Ponzi-related tax questions. The National Taxpayer Advocate mentions unresolved questions related to: the tax treatment of losses incurred by indirect investors (such as those who invested through retirement accounts and trusts), amending prior year returns to eliminate phantom income, the tax treatment of clawbacks, and the tax treatment of losses sustained by private foundations, as well as the application of the qualified settlement fund rules to receivers and other fiduciaries appointed to recover assets for Ponzi scheme investors.

Although the IRS has provided some guidance related to these questions, guidance of general applicability has not been provided because of the inherently factual nature of the questions or because the law already provides a sufficiently clear answer. For example, there may be significant factual differences among taxpayers or Ponzi schemes that affect their tax treatment. In other cases, only a small number of taxpayers may be affected or the tax consequences may not be significant. The uncertainty may not arise from the law, but from questions of proof by the particular taxpayer. Similarly, the IRS may not have sufficient facts to permit broad guidance. In these situations, the IRS will continue to address questions on a case-by-case basis while closely monitoring the need for broader guidance as more information becomes available.

The IRS is committed to continue providing useful and appropriate guidance targeted to the needs of its stakeholders on Ponzi-related tax questions. The form of this guidance will necessarily depend on the nature of the stakeholder and the questions presented. Additionally, the IRS is in the process of prioritizing the recommendations of the Ponzi Scheme Working Group and will proceed with a view to balancing service with enforcement so as to effectively and efficiently address Ponzi-related tax matters.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS has issued guidance addressing some of the unsettled tax issues faced by Ponzi victims.[49] The IRS has also established a steering committee and working group to identify and address additional Ponzi-related issues, which may generate additional guidance. While existing guidance provides a "sufficiently clear answer" to some Ponzi-related questions, the IRS comments do not dispute that current law does not clearly address the specific questions described above. Similarly, while some Ponzi-related questions may be factual in nature or faced by an insignificant number of taxpayers, the IRS comments do not identify any of the questions above as falling into these categories. Moreover, the Ponzi Scheme Working Group's analysis and preliminary recommendations suggest that some in the IRS agree that additional guidance is needed.

Even if some of the questions are well settled or are factual in nature, the IRS could issue guidance using examples that address common Ponzi fact patterns by applying existing law. This would illustrate how settled law applies and assist taxpayers in applying the rules to other factual situations. We understand that some practitioners are receiving helpful guidance by calling attorneys in the IRS Office of Chief Counsel. While we believe these attorneys should be accessible, to the extent such informal advice is actually more helpful than published guidance it may provide unfair advantage to those who receive it. Thus, it may be analogous to "secret law."[50]

In any event, the IRS's failure to effectively communicate what the tax rules are before taxpayers file returns makes it more likely that similarly situated taxpayers will claim different tax results. In addition, if after taxpayers make their best guess as to what the rules are, the IRS later decides that it disagrees, the lack of published guidance may drain both IRS and taxpayer resources in avoidable controversy and litigation. This approach is analogous to informing motorists of the speed limit by handing out tickets rather than by posting a sign. Ponzi victims have already endured enough without also having to worry about conflict with the IRS. They deserve clear answers at the outset. IRS personnel also deserve clear answers so they can do their jobs. Thus, the IRS should seize upon the Madoff tragedy as an opportunity to issue the guidance needed in this area.

[49] The IRS recently provided some limited Ponzi guidance in the instructions to Form 4684, *Casualties and Thefts* (2009) by cross-referencing Revenue Ruling 2009-9 and Revenue Procedure 2009-20. It highlighted this change in Publication 529, *Miscellaneous Deductions* (2009).

[50] For a more detailed discussion about why the IRS should favor transparency over secret law, see National Taxpayer Advocate 2006 Annual Report to Congress 10-30.

Recommendations

The National Taxpayer Advocate offers the following recommendations:

1. Publish additional guidance or at least publish answers to more of the most frequently asked Ponzi-related questions. This guidance should address Ponzi issues such as those described above, including:
   - The tax treatment applicable to indirect investors;
   - When to amend prior-year returns to eliminate phantom income (including a description of the documentation that would establish the phantom income was not constructively received);
   - How to report any clawbacks;
   - How these same rules apply to private foundations;
   - How to apply the private foundation distribution rules; and
   - How private foundations may avoid the jeopardy tax.
2. Consider the Ponzi Schemes Working Group's recommendations, particularly those that the National Taxpayer Advocate finds promising, including:
   - Providing additional guidance to receivers administering Ponzi bankruptcies; and
   - Revising information returns (*i.e.*, Form 1099) to identify Ponzi-related recoveries.

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

RESPONSIBLE OFFICIALS

Richard E. Byrd Jr., Commissioner, Wage and Investment Division
Chris Wagner, Commissioner, Small Business/Self-Employed Division
Karen Hawkins, Director, Office of Professional Responsibility

DEFINITION OF PROBLEM

Tax professionals play a significant role in tax administration by facilitating return processing and representing taxpayers in audits and controversies. Individuals and businesses may grant power of attorney (POA) authority to representatives to act on their behalf before the IRS for a number of reasons, including the complexity of the Internal Revenue Code (IRC) and the need for professional assistance to timely meet tax obligations.[1] During the past five years, the number of taxpayers that appointed representatives steadily grew, from about one million in processing year (PY) 2004 to over 1.6 million in PY 2008.[2] However, IRS processes and systems designed to recognize and record POA information often entangle taxpayers and their representatives in frustrating systemic problems.

When the IRS fails to timely record a valid POA on its Centralized Authorization File (CAF)[3] system or fails to link common databases such as the Automated Lien System (ALS)[4] to the CAF, taxpayers may experience difficulties, including:

- Lack of representation or at best ineffective representation;
- Adverse IRS action;
- Lengthy delays in processing of tax returns and associated refunds; and
- Inadvertent disclosure of personal tax information.

1 More than 80 percent of all individual taxpayers find the process of filing tax returns so overwhelming that they pay for help, and about 60 percent of all taxpayers pay preparers to do the job. *See* 2007 National Taxpayer Advocate Annual Report to Congress vol. 2, 44 (Leslie Book, *Study of the Role for Preparers in Relation to Taxpayer Compliance with the Internal Revenue Laws*); John T. Scholz and Neil Pinney, *Duty, Fear, and Tax Compliance: The Heuristic Basis of Citizenship Behavior*, American Journal of Political Science, Vol. 39, No. 2, 490-512 (May 1995), http://www.jstor.org/stable/2111622 (last visited Sept. 2, 2009); Luigi A. Franzoni, *Tax Evasion and Tax Compliance* (Sept. 1, 1998), http://ssrn.com/abstract=137430 (last visited Sept. 2, 2009).

2 Individual Master File from the Compliance Data Warehouse (CDW), Processing Years 2004-2008 (Aug. 2009).

3 The CAF assigns unique identifiers to authorized representatives (Form 2848) and appointees (Form 8821) and maintains the data with linkages to the appropriate taxpayer accounts and tax modules. This system is part of Integrated Data Retrieval System (IDRS) processing.

4 The ALS supports revenue officers in field offices by tracking lien assignments and due dates. It generates notices of federal tax liens and releases of liens, and maintains a database of all outstanding items.

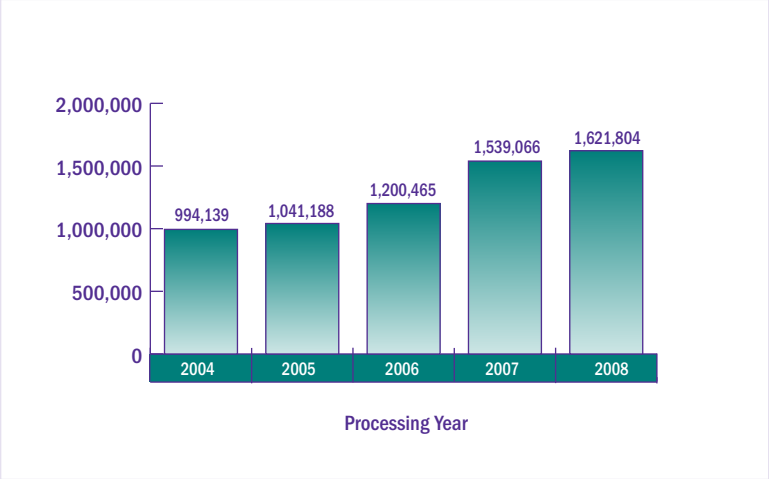
Moreover, IRS processes and systems directly harm taxpayers in cases when the IRS improperly bypasses the designated representative or does not notify a taxpayer-employer about a change of address initiated by a third party payer.[5]

ANALYSIS OF PROBLEM

Background

During the past five years, the number of taxpayers appointing a recognized representative grew by over 62 percent, as shown in Chart 1.18.1 below.[6]

CHART 1.18.1, Increasing Volume of Powers of Attorney[7]



The IRC generally prohibits disclosure of tax return information to third parties unless the taxpayer has given the IRS consent to disclose this information to a designated third party.[8] The Code's direct contact provisions specifically require IRS employees to:

- Stop a taxpayer interview whenever a taxpayer asks to consult with a representative; and

5 National Taxpayer Advocate 2007 Annual Report to Congress 337. Taxpayers that rely on third parties for withholding and depositing employment and income taxes from wages paid to their employees may not receive timely notice of tax delinquencies as a result of the address change initiated by the third party.

6 The recognized representative category includes attorneys, certified public accountants (CPAs), enrolled agents, and enrolled actuaries. In limited circumstances, a taxpayer may also grant POA authority to a member of his or her immediate family, an employee, a partner, or an unenrolled return preparer. *See* Treas. Reg. § 601.502; Form 2848, *Power of Attorney and Declaration of Representative* (June 2008). *See also* 31 C.F.R. § 10.7(c)(1)(i)-(viii).

7 IRS, Compliance Data Warehouse (CDW), Individual Masterfile (IMF) Transaction File, Processing Years 2004-2008 (Aug. 2009).

8 *See generally* IRC §§ 6103(c); 7521(b)(2) and (c); Treas. Reg. § 301.6103(c)-1; Internal Revenue Manual (IRM) 11.3.3 (Mar. 18, 2008); IRM 4.11.55.3 (Jan. 15, 2005); IRM 5.1.1.7.7 (Aug. 21, 2006).

- Obtain their immediate supervisor's approval to contact the taxpayer instead of the representative if the representative is unreasonably delaying the completion of an examination or investigation.[9]

Moreover, a taxpayer may seek monetary damages in a United States District Court if an IRS employee intentionally, or by reason of negligence, disregards these provisions by denying the taxpayer the right to appropriate representation.[10]

A taxpayer must file a power of attorney (Form 2848, *Power of Attorney and Declaration of Representative*, can be used for this purpose) with the IRS to appoint a third party to represent him or her in dealings with the IRS.[11] The CAF unit assigns a unique identifier to the authorized representative (Form 2848) or appointee (Form 8821, *Tax Information Authorization*), and maintains the data with links to the appropriate taxpayer accounts and tax modules that make up the Integrated Data Retrieval System (IDRS).[12] The process can be confusing to taxpayers, their representatives, and IRS employees alike, who are often unsure which form to use and what authorities each one grants to a POA. In April 2009, CAF issues were among the top ten systemic problems submitted to TAS by taxpayers and IRS employees via the Systemic Advocacy Management System (SAMS).[13]

CAF Unit Delays and Unlinked Databases Harm Taxpayers.

IRS employees cannot discuss taxpayer issues with a tax professional without confirmation that the taxpayer has consented to the disclosure of return or return information to the tax professional. If the IRS does not timely process POA forms and record them on the CAF database, authorized representatives will not be able to speak to the IRS about their clients' tax issues without sending in a duplicate POA form.[14] Such inefficiencies may cause delays in case resolution, increased taxpayer frustration, and adverse consequences such as additional tax, penalties, and interest. In addition, repetitive work for the tax professional may result in higher service fees for the taxpayer.

As a result of these problems, the very services designed to simplify tax professionals' interaction with the IRS often generate complaints and create IRS rework.[15] For example, tax practitioners made the following comments:[16]

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9 IRC §§ 7521(b)(2) and (c).

10 IRC § 7433.

11 *See generally* IRM 21.3.7 (Apr. 17, 2009).

12 The IDRS consists of databases and operating programs that support IRS employees working active tax cases within each business unit. This system manages data retrieved from the Master Files, allowing employees to take actions on account issues, track status, and post updates back to the Master Files.

13 TAS Business Performance Review (Apr. 2009), *Top Ten Systemic Issues Submitted to SAMS, 2nd Quarter FY09*, Appendix C-3.

14 Teleconference with Low Income Taxpayer Clinics (LITC) (Sept. 23, 2009). TAS recorded about 30 American Bar Association Low Income Taxpayer (ABA LITP) listserv submissions about delays with POA processing between Jan. 1 and Oct. 1, 2009.

15 Teleconference with American Institute of Certified Public Accountants (AICPA) members (Aug. 18, 2009) and LITCs (Sept. 23, 2009).

16 Teleconference with AICPA members (Aug. 18, 2009); ABA LITC listserv submission (June 23, 2009).

- "One out of every four contacts with e-services results in repetitive work and when my CAF number is not recognized I must contact the Practitioner Hotline or fax a new Form 2848 to the CAF Unit."
- "My 2848s are getting processed, but the IRS is not copying me on notices for about half of my clients. I am missing Collection Due Process dates because my clients think I am getting the notices, so they do not call me. I must have my clients call me when they get notices and therefore cannot rely on the CAF system to protect my clients."
- "Relationships with my clients become strained and fear of IRS is exacerbated when my clients discover that the IRS has bypassed me."

IRS policy is to send all original correspondence to the taxpayer and provide a copy to the taxpayer's authorized representative unless the taxpayer has indicated otherwise on Form 2848.[17] However, the Automated Offer in Compromise (AOIC) and the Automated Lien System (ALS) are not linked to the CAF, and therefore do not systemically copy IRS correspondence to taxpayers' representatives.[18] This deficiency only serves to increase frustration among those attempting to resolve their tax liabilities through the offer in compromise program.[19] More importantly, it can prevent taxpayers from exercising their legal right to request a collection due process hearing when the IRS files a notice of federal tax lien, and the representative does not receive a notice of the filing.[20] According to the Treasury Inspector General for Tax Administration (TIGTA), an estimated 45,554 taxpayer representatives may not have been provided lien notices in fiscal year (FY) 2008 alone.[21]

The National Taxpayer Advocate is concerned about the negative consequences of taxpayers lacking effective representation as a result of IRS systemic errors. These consequences range from taxpayers missing important deadlines to small businesses going out of business.[22] The IRS should establish an automated process to systemically upload taxpayer representative information directly from the CAF to the ALS and submit taxpayer representative notifications to the ALS for each lien when multiple liens are requested.

17 IRS Statement of Procedural Rules, Conference and Practice Requirements, § 601.506; IRM 13.1.10.3.1 (Oct. 31, 2004).

18 TIGTA, Ref. No. 2009-30-089, *Additional Actions Are Needed to Protect Taxpayers' Rights During the Lien Due Process* (June 16, 2009). The Automated Offer in Compromise (AOIC) system is used to control, track and manage OIC activities.

19 For a more detailed discussion of the offer in compromise program, see Most Serious Problem: *The Steady Decline of the IRS Offer in Compromise Program Is Leading to Lost Opportunities for Taxpayers and the IRS Alike, supra.*

20 IRC § 6320 requires the IRS to notify taxpayers in writing, at their last known address, about filings of a NFTL within five business days of the lien filings.

21 TIGTA reviewed a statistically valid sample of 125 NFTLs filed for the 12-month period ending June 30, 2008. In about one third of the cases (eight of 27) in TIGTA's statistically valid sample (where the taxpayer had an authorized representative), the IRS did not notify the taxpayer's representative of the lien filing.

22 *See* Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of Law, Fail to Promote Future Tax Compliance and Unnecessarily Harm Taxpayers, supra.* Filing an NFTL negatively affects taxpayer credit and may preclude access to business financing.

IRS Programming Can Result in Unauthorized Disclosures of Taxpayer Information.

The CAF unit assigns POA privileges to a representative for both spouses listed on a joint return in cases where only one spouse has designated a representative by the POA.[23] The CAF unit may be affecting the rights of the unrepresented spouse by assigning the representative POA privileges for that spouse because other IRS employees will assume that the representation exists and interact with the representative as though he or she represents both spouses.

Because its computer systems cannot distinguish cases with a POA applicable to only one taxpayer on a joint return, the IRS has recorded flawed POA information about these cases on the CAF database.[24] The CAF unit is aware of this situation and is working on reprogramming systems to allow for separate POAs for each spouse on a joint return.[25] The National Taxpayer Advocate is pleased that the IRS is taking corrective action and looks forward to the expeditious resolution of this matter.

Taxpayers Are Harmed When Low Income Taxpayer Clinics Are Unable to Provide Timely Service.

The Low Income Taxpayer Clinic (LITC) program helps qualifying organizations provide free or nominal fee legal assistance to low income taxpayers in resolving tax disputes with the IRS.[26] Some clinics are associated with a law or accounting school, with students working under the supervision of an attorney or CPA faculty member and receiving academic credit for assisting taxpayers. A lead attorney or CPA from an authorized clinic is listed as a primary representative on the POA form (Form 2848), with the student's name on the next line.[27] When a taxpayer authorizes a student enrolled in an LITC or Student Tax Clinic (STC) program to represent him or her under a special order issued by the Office of Professional Responsibility (OPR), a copy of the OPR special order letter authorizing practice before the IRS must be attached to the power of attorney form (Form 2848) and submitted to the CAF unit.[28] However, under current guidelines, the student's authorization is automatically purged from the CAF 130 days after the POA is received by the CAF.[29] By the very nature of the community and clientele the LITCs serve, requiring clinics to repeatedly resubmit POAs is not only burdensome and time consuming but also exacerbates the tax complications for low income clients.[30] The IRS should design an expedited process allowing LITC/STC directors who have an absolute responsibility to monitor their student

23 IRS Wage and Investment (W&I) division response to TAS research request (Aug. 24, 2009).

24 *See* Most Serious Problem: *The IRS Mismanages Joint Filers' Separate Accounts, infra.*

25 W&I response to TAS research request (Aug. 24, 2009). Programming changes to allow a secondary spouse and his/her representative should be initiated by January 2010. W&I Procedures & Guidance work request, Ref. No. SCA0808220TH, Centralized Authorization File/Masterfile Primary and Secondary Taxpayers. *See also* Systemic Advocacy Management System Project 28109.

26 IRC § 7526; IRM 21.3.4.10.4 (Oct. 1, 2008).

27 IRM 21.3.7.5.2 (Oct. 26, 2009); Form 2848 instructions (June 2008).

28 IRM 21.3.7.9.6 (Oct.26, 2009); IRM 5.1.10.5.2 (Aug. 21, 2006).

29 Instructions for Forms 2848 (June 2008). At the end of 130 days after input to the CAF, they are automatically purged from the CAF.

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

POAs and a duty of care to their clients and the IRS according to Circular 230, to renew and revoke their student representatives' authorizations simply by submitting the change in writing, without resubmitting Form 2848.[31] The CAF unit should also designate an account manager for the LITCs to routinely resolve POA problems specific for this specialized group that is partly funded by the IRS.

IRS Employees Often Do Not Adhere to Taxpayer Representative Designations, Thus Violating the Direct Contact Provisions of IRC § 7521.

When IRS employees are unaware of a POA, fail to verify its validity, or even worse, simply ignore legal requirements and IRM procedures and directly contact the represented taxpayers, the resulting "bypass" violates an important taxpayer right.[32] TIGTA's 2009 annual review of restrictions on directly contacting taxpayers revealed at least six complaints in which IRS employees improperly bypassed representatives and were either counseled or reprimanded for their actions.[33] Recently, TAS performed an informal review of 562 TAS cases and found eight cases with a potential POA bypass violation where IRS employees either did not follow established IRM procedures or, being aware of a designated representative, contacted the represented taxpayer directly.[34] Only one of the eight cases had been elevated to TIGTA for investigation.

The IRS does not collect or measure information regarding adherence to IRC § 7521(b) and (c).[35] In the absence of an effective measurement system, the National Taxpayer Advocate is very concerned about the potential volume of POA bypass violations. The IRS should establish a process for gathering and tracking taxpayer and POA complaints on direct contact violations and provide, at minimum, mandatory annual training for all contact employees.

The IRS Should Send Dual Confirmation Letters for Address Changes of Taxpayers Using Third Parties.

When a POA changes a taxpayer's address of record with the IRS, and the IRS does not notify the taxpayer, he or she may be left unaware of any tax delinquencies created by the representative's actions. For example, in the *Firstpay* case,[36] a third party payer (TPP) routinely requested its customers to sign a POA on Form 2848, and then changed their addresses on Forms 941, *Employer's Quarterly Federal Tax Return,* to its own, so that the

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31 Treas. Dept. Cir. No. 230, 31 CFR, Subt. A, Pt. 10.

32 The Omnibus Taxpayer Bill of Rights created safeguards to protect taxpayers being interviewed by IRS employees as part of an examination or investigation. Pub. L. No. 100-647, 102 Stat. 3730 (1988); IRC § 7521(b)(2) and (c). *See also* IRM 4.11.55.3 (Jan. 15, 2005); IRM 5.1.1.7.7 (Aug. 21, 2006).

33 TIGTA, *Fiscal Year 2009 Statutory Review of Restrictions on Directly Contacting Taxpayers*, Ref. No. 2009-30-054 (Mar. 24, 2009). IRC § 7803(d)(1)(ii) requires TIGTA to annually evaluate the IRS's compliance with the direct contact provisions. The TIGTA investigations noted occurred between October 2007 and September 2008.

34 TAS Taxpayer Advocate Management Information System (TAMIS) cases were searched using the words *POA or Bypass* in a string search of Primary Core Issue Codes (PCIC) 130, 600-690, 700-790, and 900-990. TAS reviewed cases established on TAMIS between May 22, 2006 and May 21, 2009.

35 SB/SE response to TAS research request (Aug. 3, 2009).

36 *Wolff v. U.S. (In re: Firstpay, Inc.)*, No. 03-30102, 2006 Bankr. LEXIS 2339 (Bankr. D. Md. Aug. 17, 2006).

affected employers did not receive delinquency notices from the IRS.[37] The IRS Criminal Investigation function found thousands of such notices at the defunct TPP's place of business.[38] Acting on the National Taxpayer Advocate's recommendation, the Small Business/Self-Employed division's Collection Policy function, IRS Chief Counsel, and TAS created a team in 2009 to work on the dual change of address notices alerting taxpayers that a third party has initiated a change of address. Although Chief Counsel found no legal prohibition to IRS sending such dual confirmation letters to the taxpayer's prior and new addresses under IRC § 6103(e), the IRS has not implemented this change, citing insufficient funding and cost concerns.[39] The National Taxpayer Advocate insists on expeditious implementation of dual address change letters (referred to as "Are You There?" letters). TAS will continue monitoring IRS efforts on resolving this issue.

CONCLUSION

The National Taxpayer Advocate applauds the recent IRS initiatives to improve the POA process, including a paperless CAF unit to replace the current system by the end of 2010.[40] However, the IRS can do more to provide taxpayers and their representatives the best service possible.

The National Taxpayer Advocate offers these preliminary recommendations:

1. Establish an automated process to systemically upload taxpayer representative information directly from the CAF to the Automated Lien System and submit POA notifications to the ALS for each lien when multiple liens are requested;
2. Reprogram the CAF system to allow for separate POAs for each spouse on a joint return;
3. Allow LITC/STC directors to renew and revoke their student representatives authorizations simply by submitting such change in writing, without resubmitting Form 2848;
4. Designate an account manager within CAF unit specifically dedicated to LITCs;
5. Establish a process for gathering and measuring taxpayer and POA complaints on direct contact violations and provide mandatory annual training to employees; and

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37 Present law does not define the term "third party payer," nor does it specifically authorize the IRS to promulgate regulations to that effect. Generally, IRC § 3504 allows employers to designate agents to act on their behalf to perform duties such as payment of employee wages and company payroll taxes. The IRS currently regulates only designated Form 2678 agents and reporting agents. *See generally* IRC § 3504; Treas. Reg. § 31.3504; Rev. Proc. 70-6, 1970-1 C.B. 420; Rev. Proc. 2007-38, 2007-1 C.B. 1442; Notice 2003-70, 2003-2 C.B. 916.

38 FirstPay, Inc., a payroll service provider business, defrauded its clients of millions dollars in employment taxes. *See* National Taxpayer Advocate 2007 Annual Report to Congress 337 (Most Serious Problem: *Third Party Payers*).

39 IRS Office of Chief Counsel Memorandum, Ref. No. PRESP-116879-09, *Use of Dual Confirmation Letters for Address Changes of Form 941 Filers Who Use Reporting Agents or Other Third Parties* (Aug. 19, 2009).

40 IRS, W&I response to TAS questions (June 22, 2009). Paperless CAF will allow automatic upload of a faxed document to the IRS computer system in a file format.

6. Implement dual address change letters ("Are You There?" letters) alerting taxpayers that a third party has initiated a change of address.

IRS COMMENTS

Processing Forms 2848 and 8821

The IRS agrees that tax professionals play a significant role in tax administration. To protect taxpayer privacy, a legal authorization is necessary before the IRS can disclose information or allow a third party to act on behalf of the taxpayer. The two most common forms that grant the authorization are Form 2848, *Power of Attorney and Declaration of Representative*, and Form 8821, *Tax Information Authorization.* Both forms can be mailed to the IRS or submitted online through e-Services.

Generally, both Forms 2848 and Forms 8821 are recorded on a database known as the Centralized Authorization File. The CAF is a stand-alone system. Using the CAF, IRS employees can identify the types of authorization given to taxpayer representatives. However, there is currently no systemic interface between the CAF and the Automated Lien System. As a result, representative information must be manually input to ALS when a lien request is initiated to ensure the taxpayer's representative receives the required copy of the IRS lien notice. The National Taxpayer Advocate recommends linking ALS with the CAF database. This recommendation was previously made by TIGTA, and the IRS has already agreed to determine the feasibility of establishing an automated process that would systemically upload taxpayer representative information directly from the CAF to the ALS system. If feasible, the IRS will request and implement the required programming enhancements.[41]

With regard to the National Taxpayer Advocate's comments regarding CAF unit delays, the IRS processes all Forms 2848 and Forms 8821 in accordance with the processing timeframes set forth in the IRM for domestic and international authorizations. All paper authorizations submitted via fax or mail require research to ensure the accuracy of the authorization and representative/appointee qualifications. In addition, the appropriate representational authority must be recorded on the taxpayer account. Third-party authorizations submitted via paper take two to five days to process depending on the method of receipt; fax or mail. Our review system shows the IRS generally meets these timeframes. The National Quality Review (NQRS) results for timeliness over the past four fiscal years reflect at least 96.7 percent timeliness each year, exceeding the annual goal of 95 percent. In addition, the NQRS results for quality review of the inputs, which include the completeness and validity of the information, improved 3.3 percent, from 91.3 percent for fiscal year 2006 to 94.3 percent in fiscal year 2009.

While both IRS timeliness and accuracy in processing paper/fax authorizations are very high, delays in processing authorizations occur when the paper form is incomplete or

41 TIGTA, Ref. No. 2009-30-089, *Additional Actions Are Needed to Protect Taxpayers' Rights During the Lien Due Process* (June 16, 2009).

improperly executed. Many rejected forms have missing representative or taxpayer signatures or signature dates. Other times, the tax years and forms are not properly specified. For example, statements such as "all periods" or "all future periods" cannot be honored. Forms that cannot be processed are returned to the taxpayer. When an authorization is returned, a history item is recorded on both the IDRS and the Accounts Management System (AMS). As a result, if a representative or taxpayer calls to inquire about account-related issues and the POA is not on the CAF, the IRS employee will research IDRS or AMS and instruct the taxpayer or representative to fax a processable authorization. To provide guidance and avoid such delays, there are detailed instructions for both Form 2848 and Form 8821. The IRS also publishes a brochure, Publication 4245, *Power of Attorney Preparation Guide*, that provides taxpayers and their representatives with helpful hints on how to avoid common errors when preparing POAs.

As an alternative to faxing or mailing a paper authorization, the IRS provides an electronic self-assistance option for most practitioners, Electronic Return Originators, and those covered by Treasury Circular 230. The Disclosure Authorization (DA) product is a part of the e-Services suite available to tax practitioners through IRS.gov. DA allows e-Services participants to electronically submit authorizations that instantaneously update the CAF database, allowing the representative immediate access to a taxpayer-client's account information.

The IRS is constantly looking for ways to improve practitioner and taxpayer understanding of the POA process and forms. Currently, the IRS is working on enhancements to clarify Forms 2848 and 8821 and their instructions in an effort to further reduce errors. To this end, the IRS provided a seminar at the 2008 and 2009 IRS Nationwide Tax Forums to enhance the knowledge of tax professionals on the third party authorization processes. *Power of Attorney and Other Third Party Authorizations* was a detailed presentation on establishing and clarifying the different types of third party authorizations that covered unenrolled return preparers, check box authority, reasons for rejection of Form 2848 and Form 8821, withdrawal or revocation of Form 2848 and Form 8821, and the DA product that is available through e-Services. Publications 4245, *Power of Attorney Preparation Guide*, and 4019, *Third Party Authorization, Levels of Authority*, were distributed at the Tax Forums. In addition, the use of the DA product was demonstrated at each forum as part of an e-Services workshop.

IRS Programming Can Result in Unauthorized Disclosure of Taxpayer Information.

The IRS agrees with the National Taxpayer Advocate's comments regarding joint returns where only one spouse has a designated representative. The IRS is working on systemic enhancements for secondary taxpayers to ensure notices are issued only to the appropriate spouse and representative. In addition, we have recently implemented new procedures requiring complete research of joint and individual tax year filing statuses. Tax examiners must create a separate identifying locator number which establishes an audit trail to differentiate when an authorization is filed as a joint request and research determines that one

or both taxpayers filed separately for one or more of the periods listed on the authorization. This will prevent inadvertent unauthorized disclosures in these circumstances.

Low Income Taxpayer Clinics

Taxpayers using the services of an LITC or a Student Tax Clinic may require the representational services of a student with a POA. Under current guidelines, the student's representation authorization is automatically revoked after representing the taxpayer for 130 days, up from the original 90-day timeframe allowed for student representation. The rationale for the 130-day limit is because law students can generally be expected to work in the LITC/STC program representing a particular taxpayer for a relatively short period of time. The time limit is intended to protect the confidentiality of sensitive taxpayer information. Barring further justification, the IRS is unconvinced that a student's authorization should be extended beyond 130 days solely on written request of an LITC/STC director without the taxpayer's involvement. In addition, even with the current 130-day limit, the IRS has received complaints from LITC directors stating they continue to receive IRS notices addressed to students that are no longer part of their program.

With regard to the National Taxpayer Advocate's preliminary recommendation to designate an account manager within the CAF unit specifically dedicated to LITCs, the Headquarters CAF analyst currently works closely with Special Counsel to the National Taxpayer Advocate on student representation issues. This employee already functions as a *de facto* LITC account manager and IRS does not believe a separate position is warranted.

IRC § 7521 Direct Contact Provisions

Although even one violation of the provisions of IRC § 7521(b)(2) and (c) is a matter of concern, due to the very small number of complaints involved the IRS believes that establishing a separate and dedicated system to gather and measure complaints on this issue would entail significant costs that outweigh the potential benefits. This point is acknowledged by TIGTA in the report cited by the National Taxpayer Advocate:[42]

> *"As we previously reported, IRS management information systems do not separately record or monitor cases that involve direct contact issues, and there is no legal requirement to do so. Given the small number of complaints received in this area over the years, establishing such a system may entail costs that would outweigh potential benefits."*

In addition to the annual TIGTA review, IRS provides procedural training and guidance in the IRM on this topic. Adherence to these procedures is also monitored by managers and independent reviewers during case reviews and employee case discussions. Further ongoing efforts to address this issue include:

42 TIGTA, Ref. No. 2009-30-054, *Fiscal Year 2009 Statutory Review of Restrictions on Directly Contacting Taxpayers* (Mar. 24, 2009).

- IRM 1.4.40, *Resource Guide for Managers*, is currently being updated to include more specific guidance for our managers regarding their responsibilities to ensure that a taxpayer has rights to representation. This update will be shared with TAS as part of the clearance process.
- Recruit training for newly-hired examiners provides formal instruction on adhering to POA designations. This training is delivered in the Basic Tax Compliance Officer and Revenue Agent classroom phases of training.
- The IRS continues to provide guidance on this issue through periodic communications with key field personnel. For example, an article in the October 2009 *Technical Digest* addressed pre-contact responsibilities, including reviewing IDRS information to determine whether a valid Form 2848, *Power of Attorney and Declaration of Representative*, is on file for the year(s) under examination.

Third-Party Payer Address Changes

Although the situation cited in the *Firstpay* case that is cited by the National Taxpayer Advocate occurs very infrequently, the IRS acknowledges that sometimes third-party payers change the address of the taxpayer without the taxpayer's knowledge. This can result in the taxpayer not being timely notified by the IRS of payroll tax liabilities. While the IRS is working to reduce the occurrence of such address changes, taxpayers should always use diligence in selecting a reliable and trustworthy third party payer or other third party representative. Employing a third party to prepare returns and make payroll deposits does not relieve the taxpayer of the responsibility for the information reported on the return, including the taxpayer's address or the amounts deposited on behalf of the taxpayer. Taxpayers may and should check on the status of payroll tax deposits when using a third party payer. Taxpayers may verify the amounts deposited through the Electronic Federal Tax Payment System (EFTPS) or request a transcript of their account.

Further in this regard, the National Taxpayer Advocate's statement *"[a]lthough Chief Counsel found no legal prohibition to IRS sending such dual confirmation letters to the taxpayer's prior and new addresses under IRC § 6103(e), the IRS has not implemented this change, citing insufficient funding and cost concerns"* warrants clarification. The IRS had disclosure concerns about sending address verifications to an address the taxpayer's duly authorized representative has specifically indicated is no longer the taxpayer's address of record. As a result, the IRS requested Chief Counsel's advice on the issue. Counsel concluded that while IRC § 6103 does not prohibit the IRS from sending change of address verifications to the former address, Counsel did not recommend doing so in all cases. Counsel stated that while a blanket approach to verifying the address change is not recommended, there may be some cases in which it is appropriate to send change of address verifications and urged the IRS to determine if a more targeted approach would be more effective. In addition, prior to the issuance of Counsel's advice on this issue, the IRS determined that it would be cost prohibitive to send change of address verifications in every instance an address change occurs. Nevertheless, the IRS and the National Taxpayer Advocate continue

to discuss this issue in order to arrive at a mutually agreeable and cost effective way to prevent authorized third parties from changing a taxpayer's address without the taxpayer's knowledge.

In conclusion, the IRS continues to protect taxpayer data by providing account information only to authorized parties. We strive to improve the process by providing the public with information on how to complete the needed forms and how to avoid IRS rejections and the resulting duplicate submissions. We also continue to provide guidance, training, and improved procedures for our employees on third-party authorities and work with the Taxpayer Advocate Service, Chief Counsel, and the Modernization and Information Technology organizations to further enhance and improve our systems and processes.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate commends the IRS for changing its programming to prevent unauthorized disclosures of taxpayer information regarding joint returns where only one spouse has a designated representative. TAS will continue to monitor the prompt resolution of this matter. The National Taxpayer Advocate remains concerned, however, about the IRS's lack of commitment to resolve other systemic errors and provide the best service possible to the taxpayers' representatives.

CAF Unit Processing Delays and Unlinked Databases Harm Taxpayers.

The National Taxpayer Advocate is pleased that the IRS has agreed to determine the feasibility of establishing an automated process to systemically upload taxpayer representative information directly from the CAF to the ALS. We encourage the IRS to expedite its analysis of current systems because unlinked databases may cause significant hardship for affected taxpayers.[43] If the analysis determines the result can be achieved using current systems, the IRS should give it top priority. Alternatively, the IRS should establish appropriate linkages, to systemically upload taxpayer representative information directly from the CAF to the ALS, during implementation of the next stage of the Customer Account Data Engine (CADE).[44] Before these databases are systemically linked (either using current systems or CADE), the IRS must develop additional guidance and procedures to ensure the

43 These systemic deficiencies may prevent authorized representatives from timely receiving notices of federal tax lien and prevent the taxpayers from exercising their legal right to request a collection due process hearing. IRC § 6320 requires the IRS to notify taxpayers in writing, at their last known address, about filings of an NFTL within five business days. For a more detailed discussion of adverse consequences of the notice of federal tax lien filing, see Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of Law, Fail to Promote Future Tax Compliance, and Unnecessarily Harm Taxpayers, supra.*

44 CADE is the foundation of IRS's modernization effort to design, develop, and deploy a modernized data infrastructure through incremental releases. This infrastructure houses the authoritative taxpayer account and return records, and will ultimately replace the Individual Master File (IMF).

information is manually input in a proper and timely manner, and measure the accuracy of this manual process through quality reviews.

The National Taxpayer Advocate is also concerned that while relying on the National Quality Review (NQRS) results, the IRS does not address multiple complaints and concerns from taxpayers' representatives.[45] When Forms 2848 and Forms 8821 are not routed correctly to the CAF unit because of a lost fax or a broken fax printer, the NQRS does not consider the resulting delays and may show more favorable results than actually exist.[46]

TAS teleconferences with AICPA members and the ABA Section of Taxation Low Income Taxpayer (ABA LITP) Committee identified numerous issues regarding CAF delays and identified the Memphis Campus as the most problematic.[47] For example, one practitioner complained about the CAF unit disregarding attached documents unless the attachments are faxed between pages one and two of the Form 2848.[48] This convoluted method (which is often referred to as a "CAF sandwich") is used by some practitioners to limit CAF delays. The National Taxpayer Advocate believes the IRS can and should do more to resolve actual problems and concerns of the practitioner community. One suggestion is for the IRS to hold a focus group at the 2010 Nationwide Tax Forums to hear practitioner concerns.

Low Income Taxpayer Clinics

While the National Taxpayer Advocate is pleased with the dialogue between TAS and W&I about Low Income Taxpayer Clinic POA issues that took place after the IRS formally responded to this Most Serious Problem, she remains concerned by the IRS's stance regarding LITC POAs.

Although we recognize that in general the taxpayer should designate his or her agents, the LITCs are a special case. As stated above, LITC directors have the primary and absolute responsibility to monitor their student POAs and a duty of care to their clients and the IRS according to Circular 230.[49] Students derive their authority through the LITC director (a Circular 230 representative) and must be cleared by the IRS Office of Professional Responsibility before being added to a POA.[50] Moreover, the LITCs operate under the care-

45 LITC practitioners reported to TAS over 30 complaints of CAF delays between January 1 and October 1, 2009. The IRS also recorded more than ten complaints on the Issue Management Resolution System (IMRS) which it uses "to record and monitor significant national and local issues to ensure the IRS resolves the issues and provides appropriate communication regarding the resolution." IRS, *IMRS*, http://www.irs.gov/pub/irs-ul/what_you_need_to_know_about_issue_management_resolution_system.pdf.

46 NQRS timeliness is defined as resolving an issue in the most efficient manner through the use of proper workload management and time utilization techniques. It measures the aspects of time controlled by the employees: timely actions, interim contact, and applicable timeframes met. Lost faxes or broken fax printers simply may not be measured under this attribute. For example, a recent complaint from a tax practitioner indicated that delays in posting faxed POAs to the CAF database may exceed two weeks at the Ogden Campus CAF. ABA LITP listserv submission (Nov. 20, 2009).

47 One practitioner commented about delays at the Memphis Campus CAF, "The IRS sometimes takes two to three weeks to enter the information from Form 2848 into the CAF." ABA LITP listserv submission (June 11, 2009).

48 TAS teleconference with members of the ABA LITP (Sept. 24, 2009).

49 Treas. Dept. Cir. No. 230, 31 CFR, Subt. A, Pt. 10.

50 There are currently 41 academic LITCs. A copy of the OPR special order authorizing practice before the IRS must be attached to the power of attorney form (Form 2848) and submitted to the CAF unit. IRM 21.3.7.9.6 (Oct. 26, 2009); IRM 5.1.10.5.2 (Aug. 21, 2006).

ful watch of TAS, the Government Accountability Office, and TIGTA.[51] For all of these reasons, as well as the mission of the clinics, LITCs require special rules to protect taxpayers without placing additional burden on the clinics and the CAF unit. Under current procedures, the taxpayer may authorize his or her representative (including LITC directors) to substitute or delegate authority to another representative by adding this authority in the space provided on line 5 of Form 2848. If the taxpayer authorizes the clinic director to substitute a student POA, the director must submit a second Form 2848, with a copy of the initial Form 2848 signed by the taxpayer, *for each student representative*.[52] Requiring clinics to repeatedly resubmit forms is not only burdensome and time-consuming, but also exacerbates the tax problems facing low income clients.[53] The IRS should revise Form 2848 language (or create a new simplified POA form for LITCs) to allow the LITC director, as a primary representative, to substitute student POAs at the end of an academic term with new students without submitting a second Form 2848 should the student's term end before the taxpayer's problem is fully resolved. LITC directors should have authority to simply submit a letter (or a simplified POA form) with attached new OPR special orders to a designated CAF unit employee for substitution of these student POAs or delegation of authority to new student POAs.[54] By adopting this proposal, the IRS would improve clinics' service to their low income clients, and save scarce resources that would be otherwise used for the benefit of the clients.[55]

Subsequent to the IRS response, W&I has agreed to provide TAS with contact details of the headquarters analyst devoted to LITC POA issues and allow TAS to distribute this point of contact (POC) information to the clinics, so LITC directors can contact this POC directly to resolve issues specific to LITCs. While the National Taxpayer Advocate believes the creation of the LITC account manager position within the CAF unit is preferable, TAS supports the alternative resolution of this problem.

Section 7521 Direct Contact Provisions

Although the IRS agrees with the National Taxpayer Advocate that even one violation of IRC §7521(b)(2) and (c) is troubling, it does not monitor the number of bypass violations. Such inaction sends a mixed signal to IRS employees about this important matter. When employees are unaware or simply ignore legal requirements and IRM procedures and

51 TAS oversight includes six-month and annual reviews, and site visits at least once every three years.

52 Form 2848 instructions (June 2008).

53 *See* Most Serious Problem: *Beyond EITC, the Needs of Low Income Taxpayers Are Not Being Adequately Met, supra.*

54 LITCs are required to enter into "*Pro Bono* Representation Agreements" with all clients, setting out the terms of representation (including naming the issue(s) and indicating that there is no fee or a nominal fee). Therefore, the clinics could be required to add a line to the *pro bono* representation agreement informing the taxpayer that at the end of semester another student may be substituted, the taxpayer has the right to request another student, and that the Clinic Director or other faculty member remains the primary representative.

55 IRM 21.3.7.9.6 (Oct. 26, 2009); IRM 5.1.10.5.2 (Aug. 21, 2006).

directly contact the represented taxpayers, knowing that the IRS does not measure these contacts, the resulting "bypass" violates an important taxpayer right.[56]

Although the TIGTA report was based on actual investigations, the National Taxpayer Advocate has a reason to believe that many complaints are not elevated to TIGTA.[57] The above-mentioned TAS discussions with AICPA members and the ABA LITP Committee indicated that POA bypass occurs rather often.

Moreover, the National Taxpayer Advocate strongly disagrees with the IRS's statement that the cost of a POA bypass measuring system would outweigh the benefits to taxpayers. When the IRS has not even analyzed the cost of such a system, the argument about "significant cost" does not appear credible. In the absence of an effective measurement system, the National Taxpayer Advocate is very concerned about the potential volume of POA bypass violations. Therefore, at the very least the IRS should analyze the cost of implementing a process to gather and measure IRC § 7521 complaints as soon as possible.

Third-Party Payer Address Changes

The National Taxpayer Advocate disagrees with the IRS's statement that misappropriation of client funds by third-party payers "occurs very infrequently." Moreover, when such misappropriation occurs, it creates millions of dollars in unpaid payroll taxes for thousands of taxpayers across the country.[58] For example, in one recent case, a third-party payer allegedly misappropriated clients' tax funds instead of paying their federal and state employment tax liabilities and "kept [its] clients in the dark for more than a year" partly by filing change of address forms with the IRS.[59] As a result, the payroll service provider, not the client employers, received IRS notices and demands for payment. Between FY 2007 and FY 2009, as a result of the IRS's recommendations, the Department of Justice (DOJ) criminally prosecuted at least 15 owners and operators of different types of third-party payers who collected approximately $216 million in employment taxes from their client employers and did not pay them over to

56 The Omnibus Taxpayer Bill of Rights created safeguards to protect taxpayers being interviewed by IRS employees as part of an examination or investigation. Pub. L. No. 100-647, 102 Stat. 3730 (1988); IRC § 7521(b)(2) and (c). *See also* IRM 4.11.55.3 (Jan. 15, 2005); IRM 5.1.1.7.7 (Aug. 21, 2006).

57 TAS's informal review of 562 TAS cases found eight with a potential POA bypass violation, of which only one had been elevated to TIGTA for investigation. Taxpayer Advocate Management Information System (TAMIS) cases were searched using the words *POA or Bypass* in a string search of PCIC 130, 600-690, 700-790 and 900-990. TAS reviewed cases were established on TAMIS between May 22, 2006, and May 21, 2009.

58 *See, e.g.*, 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).

59 *See* Adam Sichko, *Owner of Ballston Spa Payroll Company Pleads Guilty to Larceny*, Bus. Rev. (Albany) (Nov. 2, 2007), *available at* http://www.bizjournals.com/albany/stories/2007/10/29/daily45.html. The article described 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. 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 was scheduled to be sentenced in January 2008.

the Treasury.[60] However, the IRS maintains that "it would be cost prohibitive to send change of address verifications in every instance an address change occurs."

While pleased with the continuing dialogue between TAS and the IRS on this matter, the National Taxpayer Advocate is confident that the benefits of dual address change letters ("Are You There?" letters) to the affected employers and the government outweigh any cost-related concerns. Moreover, the National Taxpayer Advocate has always recommended a targeted approach to verifying the address change in only employment tax cases where the third party payer has access to the client employer's funds. Therefore, the National Taxpayer Advocate urges the IRS to promptly begin using a dual address change letter alerting employers that a third party has initiated a change of address.

Recommendations

The National Taxpayer Advocate recommends that the IRS take the following specific actions:

1. Expedite the analysis of current systems' ability to systemically upload taxpayer representative information directly from the CAF to the ALS and submit POA notifications to the ALS for each lien when multiple liens are requested.
2. Until working linkages are established via current systems or CADE, develop additional guidance and procedures to ensure the POA information is manually input and monitored through quality review procedures.
3. Allow LITC/STC directors to renew and revoke their student representatives' authorizations simply by submitting such change in writing, with attached OPR special orders, and without repeatedly resubmitting Forms 2848.
4. Permanently assign a CAF unit employee dedicated to LITC POA issues and make the information about this point of contact (POC) available to TAS, so that TAS can provide this POC information or changes therein directly to the LITCs.
5. Establish a cost-effective process for gathering and measuring taxpayer and POA complaints on direct contact violations.
6. Implement dual address change letters ("Are You There?" letters) alerting employers that a third party has initiated a change of address in cases where the third party payer has access to the client employer's funds.

60 *See generally Employment Tax Investigations FY 2009*, http://www.irs.gov/compliance/enforcement/article/0,,id=187270,00.html; *Employment Tax Investigations FY 2008*, http://www.irs.gov/compliance/enforcement/article/0,,id=174631,00.html; *Employment Tax Investigations FY 2007*, http://www.irs.gov/compliance/enforcement/article/0,,id=163012,00.html (last visited Nov. 23, 2009).

MSP #19

The IRS Mismanages Joint Filers' Separate Accounts

RESPONSIBLE OFFICIALS

Richard E. Byrd Jr., Commissioner, Wage & Investment Division
Chris Wagner, Commissioner, Small Business/Self-Employed Division
Diane Ryan, Chief, Office of Appeals

DEFINITION OF PROBLEM

The IRS creates, on average, more than 87,000 accounts each year when it separates the accounts of married taxpayers who file joint returns.[1] Unless the IRS properly manages these separate accounts, taxpayers are harmed in the following ways:

- The IRS may engage in unlawful collection actions due to a miscalculation of the period of limitations on collection on the separate account. If the period of limitations on refunds has already expired when the error is identified, the IRS may not be able to reverse its error;
- The IRS may apply payments to the wrong account. This triggers erroneous refunds with respect to the account to which the payment was erroneously applied, and inappropriate collection activity with respect to the account for which the payment was intended;
- The IRS may not timely create the separate accounts, or the IRS taxpayer assistor may not realize that separate accounts exist. As a consequence, both the IRS and the taxpayer may be confused about the existence or amount of the taxpayer's liability; and
- The IRS may improperly disclose one joint filer's personal information to the other joint filer's representative.

The National Taxpayer Advocate identified problems with the IRS's management of joint filers' separate accounts as a Most Serious Problem in the 2003 Annual Report to Congress.[2] Although the IRS has made some improvements, as noted in the 2005 Annual Report,[3] procedures for monitoring these accounts have been largely unexamined.

1 *See* Chart 1.19.1, *infra*, 2007-2009. The IRS created 98,030 MFT 31 accounts in fiscal year (FY) 2007; 85,024 in FY 2008; and 79,308 in FY 2009. The IRS creates separate accounts when 1) joint liability is interrupted and the joint filers become liable for different amounts; 2) the joint filers become subject to different periods of limitation on assessment or collection; or 3) collection activities are prohibited against one, but not both, of the joint filers. *See* IRM 21.6.8.3 (Oct. 1, 2009) for a list of specific events that trigger the creation of separate accounts.

2 National Taxpayer Advocate 2003 Annual Report to Congress 170.

3 National Taxpayer Advocate 2005 Annual Report to Congress 328.

The Customer Account Data Engine (CADE), which will eventually replace the Master File Tax (MFT) system on which most taxpayer accounts are stored, would not forestall or correct the problems that arise when joint filers' accounts are not properly separated or managed, and any future adaptation of CADE to address these problems will not provide relief for years.[4] Joint filers whose accounts are not being properly managed need immediate relief.

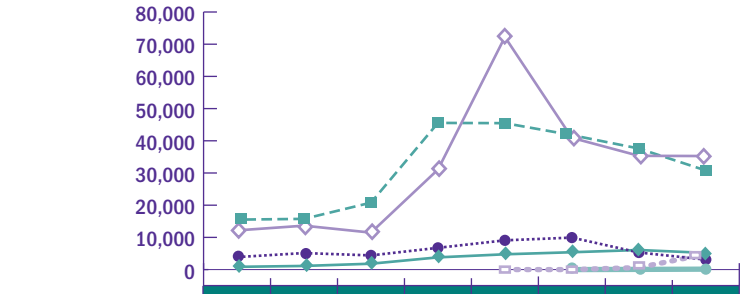
ANALYSIS OF PROBLEM

Background

The Current IRS Inventory of Joint Filers' Separate Accounts Is Substantial.

Since 2002, the number of joint filers' separate accounts, designated as MFT 31 accounts, has generally increased, with a spike in 2006 that coincided with a change in the bankruptcy law.[5] Chart 1.19.1 shows the number of MFT 31 accounts by year of account creation and category.[6]

CHART 1.19.1, MFT 31 Accounts Established FY 2002-2009 by Triggering Event



	FY 02	FY 03	FY 04	FY 05	FY 06	FY 07	FY 08	FY 09
Bankruptcy	12,167	13,637	11,483	31,061	72,235	40,921	35,333	35,267
IRC §6015 Claims	15,515	15,750	20,791	45,553	45,476	41,767	37,600	30776
OIC	3,878	5,133	4,405	6,757	9,084	9,935	5,304	3,098
Tax Court	850	1,130	1,824	3,795	4,750	5,387	6,080	5,183
IA	–	–	–	–	1	1	619	4,833
CNC	–	–	–	–	–	1	59	133

4 *See IRS CADE Processing System Tops 15 Million Tax Returns*, IR-2008-39 (Mar.12, 2008) *available at* http://www.irs.gov/newsroom/article/0,,id=180038,00.html. CADE is to be released in phases, with the next release scheduled for 2012. The 2012 release does not accommodate a processing change for MFT 31 accounts. The next release of CADE thereafter is scheduled for 2014. Response from CADE project office (Aug. 25, 2009).

5 The 2006 increase in IRS bankruptcy cases followed the 2005 surge of filings before the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), Pub. L. No. 109-8, 119 Stat. 23 (2005), took effect on Oct. 20, 2005.

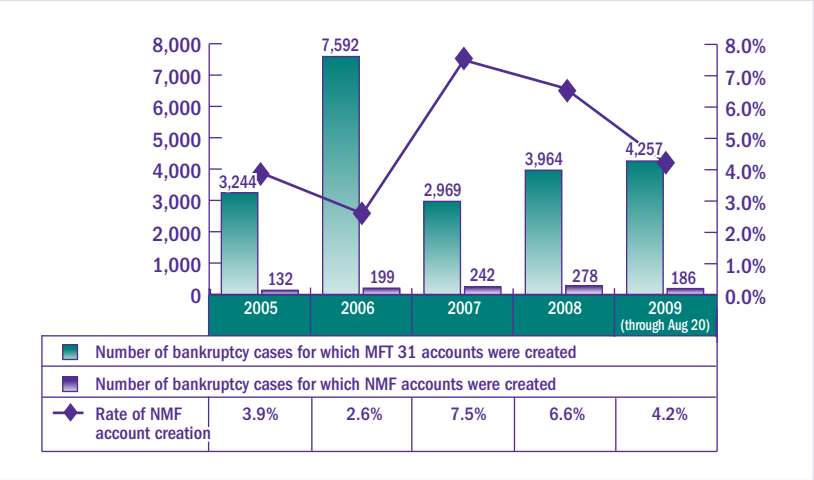
6 TAS Research analysis of MFT 31 accounts created during FY 2002 through FY 2009. Where the triggering event was a claim for innocent spouse relief, MFT 31 accounts were established for both spouses beginning in 2005; prior to 2005 only the account of the requesting spouse was established in MFT 31. These totals do not include non-master file (NMF) accounts, discussed *infra*. The bankruptcy category includes not only single petitions, but also joint petitions resulting in discharge of only one spouse. The Offer in Compromise (OIC) category includes not only approved separate offers but also defaults of accepted joint OICs by only one spouse. *See* Internal Revenue Manual (IRM) 21.6.8.3 (3) (Oct. 1, 2009).

The two most common triggers of MFT 31 account creation from 2002 through 2009 were bankruptcy and claims for relief under Internal Revenue Code (IRC) § 6015.

The Extent to Which Systemic Limitations Prevent the IRS from Creating MFT 31 Accounts Is Uncertain.

When systemic limitations prevent the IRS from creating MFT 31 accounts, the IRS creates non-master file (NMF) accounts.[7] NMF accounts are not part of the main system of records, or master file, on which most taxpayer records are stored. Retrieving records from NMF requires special access and specialized knowledge of how the database operates, which means that some IRS employees who assist taxpayers cannot fully research taxpayer accounts, or may overlook the existence of an NMF account altogether.[8] Chart 1.19.2 shows the number of bankruptcy cases which resulted in the creation of an MFT 31 or NMF account from 2005 to 2009:[9]

CHART 1.19.2, Number of Cases in Which MFT 31 and NMF Accounts Were Created in Response to Bankruptcy as a Triggering Event FY 2005-2009



The number of cases resulting in the creation of NMF accounts, as a percentage of the number of cases resulting in the creation of MFT 31 accounts in response to the same

7 Examples of conditions that prevent creation of MFT 31 accounts are: one of the joint filers has an invalid Taxpayer Identification Number (TIN); one of the joint filers has an Individual Taxpayer Identification Number (ITIN); there is a Criminal Investigation indicator on the joint account; or the joint account shows that more was paid than was due (*i.e.*, a credit balance account). IRM 25.15.15.2.1 (July 17, 2009). *See also* IRM 25.15.7.7.1(7) (July 17, 2009).

8 For example, Taxpayer Advocate Management Information System (TAMIS) case file 4191741 details the inability of the IRS's Accounts Management function to process a TAS Operations Assistance Request to adjust errors on an NMF account.

9 IRS response to TAS information request (Aug. 21, 2009). The Wage and Investment (W&I) division was not able to report what proportion of the processable claims for relief under Internal Revenue Code (IRC) § 6015 resulted in MFT 31 accounts and what proportion of the claims resulted in NMF accounts. Nor could the Small Business/Self-Employed division (SB/SE) identify the number of MFT 31 accounts or NMF accounts that were created in response to the OIC trigger (until 2008, the third largest trigger for creation of MFT 31 accounts), or even the number of accepted OICs that applied to only one spouse. IRS responses to TAS information requests (July 23, 2009, Aug. 21, 2009).

bankruptcy trigger, ranged from 2.6 percent to 7.5 percent over the five-year period. This variability suggests that the IRS inconsistently creates separate accounts and thereby provides inconsistent taxpayer service.

The Extent to Which the IRS Fails to Create MFT 31 Accounts Even When Possible and Appropriate Is Uncertain.

The IRS reported processable claims for relief under IRC § 6015 as shown in Table 1.19.3. Given that an MFT 31 account is created for each spouse when a processable claim is submitted, then the anticipated number of MFT 31 accounts should be roughly double the number of processable claims.[10]

TABLE 1.19.3, Processable Claims for Relief Under IRC § 6015 Compared to Anticipated and Actual MFT 31 Accounts

	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009
Processable Claims for Relief under IRC § 6015[11]	29,485	27,930	25,522	25,349	30,612
Anticipated MFT 31 Accounts (*i.e.*, roughly double the number of processable claims)	58,970	55,860	51,044	50,698	61,224
MFT 31 Accounts Actually Created[12]	45,553	45,476	41,767	37,600	30,776
Rate of Discrepancy Between Anticipated and Actual MFT 31 Accounts	22.8%	18.6%	18.2%	25.8%	49.7%

As Table 1.19.3 shows, the 2006 discrepancy rate of 18.6 percent more than doubled by 2009. The difference between the number of anticipated MFT 31 accounts triggered by the filing of a processable claim for relief under IRC § 6015 and the number of MFT 31 accounts actually created in response to that triggering event ranges from 9,000 to more than 30,000 annually.[13] Even the assumption that some of the anticipated MFT 31 accounts resulted in NMF accounts, rather than MFT 31 accounts, does not explain the difference. The IRS does not track the number of processable IRC § 6015 claims that result in neither MFT 31 nor NMF accounts.[14]

Mismanagement of Joint Filers' Separate Accounts Results in Impermissible Collection Activity by the IRS as Well as Other Burdens to Taxpayers.

In a sample of 3,105 MFT 31 modules (tax accounts) that it examined, TAS estimated that approximately 1,100 modules (*i.e.*, 35 percent) had erroneous collection statute expiration dates (CSEDs) that arose when account data was incorrectly transferred from joint accounts

10 The number of anticipated MFT 31 accounts should be double the number of processable claims, reduced to the extent systemic limitations prevent the IRS from creating them.

11 IRS responses to TAS information requests (July 23, 2009 and Oct. 13, 2009).

12 TAS Research (Oct. 13, 2009).

13 In FY 2007, the difference was 9,277; in FY 2009, the difference was 30,448.

14 IRS responses to TAS information request (July 23, 2009).

to MFT 31 accounts.[15] The IRS collected tax when the CSED had expired.[16] W&I agreed to correct the procedure that led to this specific error and to refund overpayments as appropriate, but the period of limitations on refunds had already expired in 856 of the 3,105 modules in the TAS sample.[17] Even where specific "fixes" are forthcoming (but not necessarily available to all injured taxpayers), this example demonstrates the lack of systematic IRS reviews or measures that would have identified the problem, provided relief to all affected taxpayers, and resulted in additional measures to prevent the problem from recurring.

A review of cases on the Taxpayer Advocate Management Information System (TAMIS) shows a variety of other errors in the management of MFT 31 accounts. These errors tend to arise because MFT 31 accounts require more processing than others, including more frequent manual intervention. For example, when an MFT 31 account is created, the IRS must "zero out" the joint account (*i.e.*, reduce it to zero) and transfer any balance due to the MFT 31 account.[18] In a sample of 17 modules involving joint accounts or MFT 31 accounts, this first step had been omitted in four modules, and the consequences were:

- Taxpayers with MFT 31 accounts continued to receive collection letters with respect to the balance shown on the joint account, which should have shown a zero balance.
- In one of these four modules, the taxpayer's Economic Stimulus Payment was offset to pay the balance due erroneously shown on the joint account.
- In two of the four modules, the inappropriate collection activity culminated in levies.[19]

Other examples of MFT 31 account mismanagement are:

- An IRS telephone assistor may not realize that a separate MFT 31 account (with a balance due) exists or should be created. The assistor reviews the zeroed out joint account and may erroneously inform taxpayers or practitioners that no tax is owed.[20]
- A lapse of time between the zeroing out of the joint account and the creation of the MFT 31 account may cause the IRS to release a tax lien associated with the joint account because it has a zero balance, rather than transferring the lien to the MFT 31 account. The taxpayer is confused as to the existence of the liability and the IRS foregoes legitimate collection activity.[21]

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15 Systemic Advocacy Management System (SAMS) Project 11034 (formerly 0029060). The same or related problem had been reported by SAMS issues I0000907, I0003709, I0004152, I0025792, I0026425, I0026596, I0026682, and I0027119, beginning as early as 2003. *See also* Most Serious Problem: *IRS Policies and Procedures for Collection Statute Expiration Dates Adversely Affect Taxpayers, supra.*

16 Joint W&I/TAS study that resulted from SAMS Project 11034.

17 IRS corrective procedures include issuing employee information alerts as appropriate, writing a training guide, and providing training. Nevertheless, data transfer problems continue to arise. For example, a "restricted interest" condition in which the interest computation is affected by a particular statutory provision (*see* IRM 20.2.8-1 (July 31, 2001)) may not be properly recorded in the MFT 31 account. *See* SAMS issue 15532 (June 29, 2009).

18 IRM 21.6.8.5.1 (6) (Oct. 1, 2008).

19 TAS review of TAMIS cases (Sept. 14, 2009).

20 *See* TAMIS case files 4392156 and 4036152.

21 SAMS Issue 15979 (Aug. 26, 2009). The MFT 31 account in this case was created because one of the joint filers entered into an installment agreement. As discussed *infra*, the IRS recently added this event as one that triggers creation of MFT 31 accounts.

- The IRS may improperly credit the taxpayer's electronic payments to the joint account rather than apply them to the MFT 31. The taxpayer receives collection notices with respect to the MFT 31 account for which payment was submitted.[22] Similarly, the IRS may apply installment payments intended for an MFT 31 account to the joint account that has a zero balance, which results in a refund. Not only must the taxpayer return the refund checks issued with respect to the joint account, but he or she also encounters the risk that the installment agreement associated with the MFT 31 account will be treated inappropriately by the IRS as in default.[23]
- The IRS may apply the same payments or credits to the joint filers' separate accounts at different times, leading to differences in the amounts of interest and penalties computed with respect to each filer, an error that requires manual adjustment.[24]

A subsidiary problem that arises with respect to MFT 31 accounts concerns the relationship between the IRS's taxpayer account database and the Centralized Authorization File (CAF) database on which taxpayers' powers of attorney (POAs) are stored. When the CAF unit receives a POA, it must associate (or "load") the POA with the primary taxpayer's MFT 31 account (*i.e.*, with the account of the first taxpayer listed on the joint return). As a consequence, the IRS sends communications requested by the secondary taxpayer's POA to the primary taxpayer's POA. These communications may include the secondary taxpayer's financial information, name change, address, or telephone number, information that is not to be disclosed.[25] Inappropriate disclosures in the context of MFT 31 accounts are especially troubling because a spouse who has suffered domestic abuse may be placed at greater risk if her personal information is improperly disclosed to the abusive spouse. TAS brought this problem to the attention of the IRS, which agreed to allow the CAF unit to associate a POA with only a secondary taxpayer's account.[26] The scheduled operational date for this correction is January 1, 2010.

Expanded Use of MFT 31 Accounts May Increase Taxpayer Burden.

The IRS recently developed a pilot program to use MFT 31 procedures when one joint filer enters into an installment agreement with the IRS, an arrangement that otherwise requires manual monitoring.[27] The pilot project is expected to result in the creation of 14,560

22 SAMS Project P0028871.

23 SAMS Issue 15916 (Aug. 19, 2009). The IRS erroneously refunded payments despite the provision in IRM 21.6.8.7 (6) (Nov. 13, 2008) that payments which are misapplied to a joint account should be offset to the MFT 31 account, rather than refunded.

24 TAS review of TAMIS cases (Sept. 14, 2009).

25 IRM 21.6.8.2(2) (Oct. 1, 2008).

26 IRS response to TAS information request (Aug. 24, 2009); W&I Policies, Procedures & Guidance work request reference no. SCA0808220TH, *Centralized Authorization File/Masterfile Primary and Secondary Taxpayers*. Problem addressed in SAMS Project 28109. *See also* Most Serious Problem: *IRS Power of Attorney Procedures Often Adversely Affect the Representation Many Taxpayers Need, supra.*

27 MFT 31 Mirror Assessment SB/SE and W&I Pilot provided in IRS response to TAS information request (Aug. 21, 2009). Cases in which one joint filer is in currently not collectible status, although identified as problematic, were not included in the pilot program.

additional MFT 31 accounts annually.[28] While the National Taxpayer Advocate applauds the IRS for recognizing the benefits of using MFT 31 procedures rather than manually monitoring accounts, she is concerned that more taxpayers will be burdened if the already under-monitored MFT 31 process is expanded.

Systemic Fixes are Needed Independently of CADE.

The 2012 scheduled release of the CADE processing system will not correct any of the MFT 31 account management problems.[29] Not until 2014, at the earliest, will the CADE system begin to address these concerns. Taxpayers affected by the mismanagement of their separate accounts need immediate relief.

CONCLUSION

In conclusion, the National Taxpayer Advocate offers these preliminary recommendations:

1. The IRS should systemically monitor accounts in which the triggering events for creating MFT 31 accounts are present to ensure that MFT 31 accounts are created when appropriate. The IRS should develop management reports to identify instances in which MFT 31 accounts were not created in response to a triggering event. Employees within specialized MFT 31 units in all functions in which triggering events occur should address these failures, and the IRS should revise and cross-reference the relevant portions of the IRM and direct employees to refer such instances to that specialized unit for corrective actions.
2. Once it creates MFT 31 accounts, the IRS should systematically monitor them and verify that they accurately reflect payments, do not lead to inappropriate collection activity, and do not result in inappropriate IRS communications with respect to separate accounts. This might be accomplished by each operating division examining a sample of the MFT 31 accounts in its inventory to determine whether the accounts have been properly managed, and then correct any errors identified.
3. The IRS should systemically monitor NMF accounts that it creates when MFT 31 accounts cannot be created to verify that they accurately reflect payments and do not lead to inappropriate collection activity. This might be accomplished by revising the IRM to instruct employees to refer joint accounts for which separate NMF accounts were created to the specialized units described above.
4. The IRS should program the 2014 release of CADE to prevent mismanagement of MFT 31 accounts and identify instances of systemic failure with respect to MFT 31 accounts. The IRS should also explore whether to accelerate MFT 31 account management issues to the 2012 release of CADE.

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28 Approximately 140 installment agreements meet the pilot criteria each week, and each installment agreement results in the creation of two MFT 31 accounts (one for each joint filer). As discussed *supra* note 21, creating MFT 31 accounts in response to the installment agreement trigger has already resulted in mismanagement of taxpayers' accounts.

29 IRS responses to TAS information requests (July 23, 2009).

IRS COMMENTS

The IRS maintains records of individual taxpayers' accounts on the Individual Master File (IMF). Each module on the IMF represents a specific tax return of a specific taxpayer for a specific tax period. IMF modules are further classified by type of return, known as the MFT Code. The IRS uses MFT Code 30 for Form 1040 returns.

The IRS also identifies and controls IMF tax modules by Taxpayer Identification Number (TIN), which generally is the taxpayer's Social Security number (SSN). When a married couple elects to file a joint return, the first SSN on the Form 1040 (or primary SSN) is used by the IRS to identify, control, research, or adjust the joint account. The IMF currently contains hundreds of millions of tax modules. So far during 2009 alone, over 143 million tax returns/modules have been added to the IMF.[30] During 2008, the IRS processed approximately 154.7 million individual returns, of which 56 million (or about 36 percent) were for joint filers.[31]

In the vast majority of situations involving joint filers, any subsequent credits, payments, or other adjustments are posted and maintained on their joint tax modules. However, in certain limited situations, provisions in the law make it possible to sever liability, in which case the IRS must separate a joint account and treat each taxpayer separately. These situations generally arise when only one spouse requests tax relief or the consequences of an IRS action differ for each spouse. The latter includes joint filers becoming subject to different periods of limitation on assessment or collection or when IRS collection actions are prohibited against one joint filer but not the other.

While the National Taxpayer Advocate suggests that the number of joint filer separate accounts is substantial, these situations actually affect approximately 43,500 joint accounts annually[32] (or roughly 0.08 percent of all joint filers) and are limited to situations involving:

- Bankruptcy — either spouse is discharged or dismissed from bankruptcy;
- Offer in compromise — either spouse makes an offer on a liability;
- Tax Court — either spouse petitions the tax court;
- One spouse agrees to a tax deficiency adjustment;
- Innocent Spouse claim — an assessment is made against a joint module but one spouse is fully or partially relieved of the liability;
- Taxpayer Assistance Order — either spouse files Form 911, *Request for Taxpayer Advocate Service Assistance (And Application for Taxpayer Assistance Order)*; or
- Installment agreement — either spouse requests an installment agreement.

30 IIRAPHQ Cumulative Individual Income Tax Return report for week ending Nov. 13, 2009.

31 Compliance Data Warehouse, Individual Returns Transaction File, IRTF_F1040 table

32 See National Taxpayer Advocate report *supra*: *"The IRS creates, on average, more than 87,000 accounts each year when it separates accounts of married taxpayers who file joint returns."*

Prior to 2001, in these situations, the IRS removed the joint tax module from the IMF and established two separate tax modules on the Non-Master File. However, there are limitations associated with the taxpayer account data in the NMF. Adjustments, such as payments or refunds, must be made manually and require considerably more time to process. Penalties and interest also must be manually computed and there is no automated cross-reference between the NMF and the IMF.

Beginning in January 2001, the IRS moved the process of separating joint accounts from the NMF to the IMF using a new MFT Code 31. The movement of these former NMF accounts to MFT 31 on the IMF benefits taxpayers due to the availability of automated adjustments and other computations that eliminate human error, as well as the ability of the IRS to electronically cross-reference any other IMF tax modules related to the same taxpayers.

As acknowledged by the National Taxpayer Advocate in this report and previously in 2005, the IRS further improved the process of separating joint accounts on its computer systems during 2005.[33] This process is generally referred to as "mirroring." When initiated by an employee, the mirroring process systemically establishes two MFT 31 accounts, one for each spouse's SSN. Thereafter, credits and adjustments are systemically posted to each spouse's account. For example, these systems changes enable the IRS to mirror accounts as soon as a processable Innocent Spouse request is filed, rather than after the relief request has been processed. This ensures that each new account is more timely populated with the appropriate collection statute expiration dates, adjustment actions, and other account data applicable to each spouse.

Notwithstanding the availability of the MFT 31 mirroring process, the IRS must still use the NMF to separate joint accounts in certain situations. This generally occurs when the secondary spouse has an invalid SSN, one spouse has an ITIN instead of an SSN, or there is a criminal investigation indicator on the joint account.

Creating and Managing MFT 31 Accounts

The IRS has taken the following actions to ensure the proper creation and management of separated accounts:

- Mirrored accounts systemically compute the Collection Statute Expiration Date (CSED) and Assessment Statute Expiration Date (ASED) for both spouses;
- An internal transcript generates anytime a payment should have been mirrored on an account but failed to do so; and
- MFT 31 computer programming has been updated so that offsets (reductions to credits to satisfy outstanding liabilities) will now systemically occur from a joint account (MFT 30) to the MFT 31 accounts for both the primary and secondary taxpayers on a joint return.

[33] National Taxpayer Advocate 2005 Annual Report to Congress 328.

As noted by the National Taxpayer Advocate in this report, the IRS recently joined with the Taxpayer Advocate Service to assess and correct the assignment of erroneous CSEDs on approximately 2,200 MFT 31 modules that occurred over a period of five years. This happened when errors were made by employees establishing these split assessments in connection with Innocent Spouse and Bankruptcy cases. The IRS trained a special team of employees to correct these errors, which included revising the CSED and crediting overpayments. Payments received after the corrected CSED occurred in less than half of the 1,200 cases reviewed to date. Other corrective actions include improved communications and training for IRS employees involved in MFT 31 account creation or adjustment processes. The IRS appreciated the National Taxpayer Advocate bringing this issue to our attention and the support and assistance provided in developing the necessary corrective actions.

The IRS has also requested an Integrated Automation Technologies (IAT) tool that can be used to check each TIN on a MFT 31 report to see if the mirroring process has been completed. If not, the tool will notate that the case should be manually corrected and processed as separate accounts. The tool is currently in development and is expected to be delivered in January 2010 for use in SB/SE Campus Compliance Services (CCS). The IRS will also consider the feasibility of expanding the use of similar IAT tools elsewhere, including in the Innocent Spouse program.

Non-Master File

As previously mentioned, if an account cannot be systemically established with a MFT 31, it must be manually established on the NMF. IRS makes every attempt to establish MFT 31 accounts on the IMF. Nevertheless, there are many conditions that prevent the systemic mirroring of accounts. Entity issues (invalid TIN, name/SSN mismatch, use of ITIN, etc.) are the number one problem. If an entity issue is present, the systemic mirroring process fails and a NMF account must be created. This situation routinely arises when the secondary taxpayer on the joint account has taken the surname of a spouse but failed to timely notify the Social Security Administration (SSA) of the name change. When the system attempts to post to the SSN, it will not due to the name control mismatch between IRS and SSA records. Until the name/SSN mismatch is corrected, the MFT 31 account cannot be established.

In this regard, the National Taxpayer Advocate reports that variability in the percentage of bankruptcy cases resulting in creation of NMF accounts versus MFT 31 accounts indicates that the IRS inconsistently creates separate accounts and provides inconsistent taxpayer service. We disagree. This variability is wholly dependent upon the circumstances of each case. A less than five percentage point variance (2.6 percent to 7.5 percent) over a five year period fails to support this conjecture. Moreover, although use of NMF involves increased manual processes, it does not prevent delivery of effective customer service.

When an account is created on the NMF, the computer automatically generates an indicator on the taxpayer's account. IRS employees are trained to research for and recognize these

indicators. For example, NMF notices are easily identifiable because they show the taxpayer's TIN followed by the letter "N". This indicator facilitates IRS processing when replies to these NMF notices are received. These notices also contain a tear-off stub for taxpayers to send to the IRS along with their payments. The tear-off stubs show all the information required for properly processing the payments to the correct NMF accounts. Additionally, a unique toll-free number appears on all NMF notices and the IRS already has dedicated units staffed and trained to handle these NMF calls. While the process for NMF accounts may vary from the MFT 31 processes, the IRS strives to provide the same quality and level of service for NMF accounts as we do for MFT 31 accounts.

"Discrepancy Rate" for Accounts Involving IRC § 6015 (Innocent Spouse) Claims

The National Taxpayer Advocate takes the annual number of processable Innocent Spouse claims and doubles them to arrive at a number of anticipated annual MFT 31 accounts. As previously described, there are many conditions that prevent creation of a MFT 31 mirrored account. Because of these conditions, one cannot simply double the number of claims to arrive at a meaningful number of anticipated mirrored accounts. The reported "rate of discrepancy" between the number of Innocent Spouse claims and anticipated MFT 31 accounts do not reflect the result of any analysis of actual cases to determine the reasons why MFT 31 accounts were not established. Such rudimentary analysis and speculative interpretation of results does not support the suggestion that the IRS routinely fails to properly create separate accounts when warranted.

Posting Separate Accounts

The IRS acknowledges that there are some delays involved in the creation and posting of mirrored accounts. However, in most cases, these delays are inherent in the MFT 31 mirroring process itself, which still requires the IRS to receive a taxpayer's request for relief and to initiate the necessary processing. For example, the IRS employees that process innocent spouse claims normally begin the joint account separation process within ten days from the receipt of the claim for relief. Because claims for relief can be mailed to any IRS office around the country, claims received in other offices can, on occasion, take that long to reach the Cincinnati Centralized Innocent Spouse Operation where these requests are processed. Additionally, depending on the particular facts and circumstances in each case, due to the batch processing architecture of the IRS Master Files, it can also take as long as two to four weeks for the separated accounts to post, depending on whether MFT 31 or NMF accounts are involved. As noted above, the feasibility of using an IAT tool for enhanced monitoring of MFT 31 account creation for Innocent Spouse claims is under consideration.

Centralized Authorization File

Contrary to what the National Taxpayer Advocate reports, the IRS currently has the capability to associate a Power of Attorney (POA) with the correct account of a secondary taxpayer's MFT 31 account. Under current procedures, a POA received for an MFT 31 account

is processed and associated solely with that MFT 31 account. There is no systemic opportunity for mailing notices or other confidential communications to the incorrect spouse or representative, since MFT 31 accounts are separate accounts and information about the other spouse is not included. In addition, the Transcript Delivery System, an automated system accessible to tax practitioners and other authorized third-parties that delivers tax account and return information, has specifically been programmed to prevent erroneous spousal disclosures in cases where a request involves an MFT 31 account.

It is possible that the scenario and reference to January 2010 programming described in the National Taxpayer Advocate's report actually involves un-separated MFT 30 joint accounts. Where only one spouse has designated a representative on a joint account or where a representative was jointly designated but the taxpayers actually filed separately (married filing separate returns), the potential existed for inadvertent unauthorized disclosures of account information to the wrong spouse or representative. However, the IRS has initiated programming changes and issued revised instructions for employees to address this issue. For a description of the new procedures and scheduled computer programming changes, see IRS comments in response to the *Most Serious Problem: IRS Power of Attorney Procedures Often Adversely Affect the Representation Many Taxpayers Need*, included elsewhere in this report.

Customer Account Data Engine

The Customer Account Data Engine is a multi-year project that represents the cornerstone of IRS's systems modernization efforts. During 2009 through November 13, CADE processed over 40.2 million returns and issued 35.1 million refunds totaling $59 billion.[34]

CADE will ultimately replace the IRS Master File for the processing and retention of all taxpayer accounts. The benefits of CADE include daily postings of account information, the ability to issue refunds much faster, and delivery of significantly enhanced customer services due to daily updating of taxpayer account information.

CADE is a multi-year project with rigorous governance, planning, functionality development, and release processes. The system does not currently support MFT 31-type separation of joint accounts. The 2012 CADE release will incorporate the mirroring of joint accounts. However, CADE will not include the capability of interacting with external compliance or other databases until its 2014 release. At that time, CADE will have the ability to support the same or similar systemic updates and account monitoring capabilities currently available through Master File. Accessing and managing mirrored accounts through CADE will provide enhanced customer services due to CADE's ability to post transactions or modify accounts daily. The IRS will liaison with the Taxpayer Advocate Service and other affected organizations to define additional MFT 31-related requirements beginning next year.

34 IRS, *CADE Weekly Summary Report for Cycle 200946.*

Summary

In conclusion, the IRS strives to keep all taxpayer accounts correctly updated and to apply the extra effort needed when separating joint tax modules. Much of this process has been significantly improved over the last few years through additional automation. Special transaction codes alert employees to MFT 31/NMF issues and employee adherence to procedures is monitored by managers during case reviews. The IRS has systems or procedures planned or in place to monitor MFT 31 accounts to verify they have been properly created and that payments have been mirrored when appropriate. The IRS has dedicated staff trained and available to handle NMF-related customer contacts. CAF procedures ensure separated joint account information is disclosed only to authorized representatives. Finally, current plans for CADE include functionality to support the separation of joint accounts by 2012, with further enhancements and linkages to other systems possible for 2014.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate acknowledges the IRS's willingness to address problems joint filers encounter when their separate accounts are mismanaged. Further, the National Taxpayer Advocate is pleased to learn that the IRS is developing a systemic tool that will identify some occasions in which MFT 31 accounts were not properly created. However, she remains concerned that the IRS does not appreciate the extent to which joint filers' separate accounts are mismanaged or the extent of the harm this causes taxpayers.

For example, the IRS, in its response, indicates that the number of joint filers whose accounts should be separated represents only a small portion of the total number of joint filers. If the IRS intends to convey that MFT 31 account mismanagement is not a serious problem for taxpayers, we would invite the IRS to consider the situation from the perspective of taxpayers who are caught up in this mismanagement event. To address MFT 31 account errors, taxpayers must attempt to deal with the intricacies of IRS account management procedures while simultaneously attempting to defend themselves against inappropriate collection activities. For many taxpayers, this scenario is a nightmare. In any event, whether the problem is expressed as one affecting 43,500 joint accounts or 87,000 separate accounts stemming from joint accounts, the frequency with which separated accounts are mismanaged is unacceptable. This is illustrated by the 35 percent erroneous CSED rate in the sample that TAS examined and referred to the IRS. Though estimates of the actual number of accounts differ, the IRS acknowledges that in a significant number of cases it collected tax after the CSED had expired, in violation of the law.

Also of concern is that errors in managing separate accounts are often due to systemic conditions, so that a single malfunction affects many taxpayers, often taxpayers who are

simply attempting to pay their taxes. An example of this is the need to process payments and refunds by using NMF accounts, which the IRS notes "require considerably more time to process" (while simultaneously maintaining that use of NMF "does not prevent delivery of effective customer service"). Whenever the IRS uses NMF accounts, taxpayers will experience delays in resolving their tax issues because not all IRS employees have access to and know how to use the NMF. The variability in the rate at which the IRS creates NMF accounts in response to the same bankruptcy trigger is statistically significant, and the IRS should investigate its cause.

Regarding the problem of IRS communications with taxpayers, the National Taxpayer Advocate agrees that the IRS can associate a POA with a secondary taxpayer's MFT 31 account, and the IRS is correct to point out that a POA received for an MFT 31 account is processed and associated solely with that MFT 31 account. The programming planned for January 2010 is intended to correct the problem of inappropriate disclosure that arises when the spouse who is the secondary taxpayer files a separate power of attorney for the joint account. The National Taxpayer Advocate is pleased that the IRS has initiated the programming changes and has issued revised instructions for employees to address this issue.

The National Taxpayer Advocate's most serious concern, however, is that the IRS does not maintain data on MFT 31 and NMF account inventories, and thus cannot sufficiently monitor either type of account to avert or correct errors. The IRS acknowledges that it maintains the great majority of separate accounts using MFT 31, rather than in NMF (NMF accounts were used, at the most, only 7.5 percent of the time in response to the bankruptcy trigger, for example). However, with respect to the innocent spouse trigger, it attributes an 18 percent to 50 percent discrepancy between the number of MFT 31 accounts that it actually creates and the number of MFT 31 accounts that should have been created to the supposition that NMF accounts were set up instead. TAS's premise that the number of MFT 31 accounts created in response to a given trigger should be roughly double the number of joint accounts (with NMF accounts created for a small minority) is logical by comparison. If TAS's premise is erroneous, the IRS should be able to produce accurate data to establish the correct levels of MFT 31 and NMF inventories, and explain the wide variation in the rate at which it establishes MFT 31 accounts in response to the same trigger. Establishing the dimension of these populations will allow the IRS to monitor them more effectively.

The National Taxpayer Advocate is pleased that the IRS is developing systemic tools for some of its functions, providing training, and designating special transaction codes to identify NMF accounts. We hope the IRS will continue to develop the IAT tool or others that will automatically generate management reports when the IRS does not create the appropriate account in response to a triggering event. The National Taxpayer Advocate thanks the IRS for its willingness to work with TAS to define MFT 31-related issues in the 2014 CADE release, and we look forward to collaborating with the IRS in the coming years. In the meantime, however, the IRS will continue to create at least 87,000 separate accounts

each year. The IRS can do more to help taxpayers who are affected by mismanagement of their separate accounts in the coming four to five years.

Recommendations

The National Taxpayer Advocate recommends that the IRS take the following specific actions to avoid mismanagement of joint filers' separate accounts:

1. The IRS should implement a system in all IRS programs with responsibility for creating MFT 31 accounts to ascertain whether it creates MFT 31 accounts or, if necessary, NMF accounts, in response to a triggering event.
2. The IRS should monitor MFT 31 accounts and NMF accounts to verify that they accurately reflect payments, do not lead to inappropriate collection activity, and do not result in inappropriate IRS communications.
3. The IRS should develop management reports that identify instances in which it did not create MFT 31 accounts or NMF accounts in response to a triggering event or mismanaged these accounts, and describe the corrective action it took.

MSP #20

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

RESPONSIBLE OFFICIAL

Sarah Hall Ingram, Commissioner, Tax Exempt and Government Entities Division

DEFINITION OF PROBLEM

There are approximately 1.8 million[1] tax-exempt organizations (or EOs) in the United States, ranging from multi-million dollar hospitals to local Little League baseball teams. This number translates to one EO for every 169 Americans.[2] As of 2005, the most recent year for which complete data is available, "reporting" organizations represented $3.4 trillion in assets, accounted for $1.6 trillion in revenue,[3] and employed 9.4 million workers – roughly 7.2 percent of the total U.S. workforce.[4] There are 175 new tax-exempt organizations added to the rolls every day – Saturdays, Sundays and holidays included – and many of them are small entities.[5]

Tax-exempt status, no matter the size of the organization, does not excuse an organization from tax compliance and reporting obligations that can be surprisingly complex. Smaller organizations are more likely to face this complexity without the assistance of professional tax preparers. The IRS acknowledges that small exempt organizations need special help complying with the tax law, but it has no methodology to obtain comprehensive information about the services EOs need from the IRS or the manner in which they prefer to receive them.[6] Further, the informational and educational needs of 1.8 million diverse organizations, with correspondingly diverse demographics, resources, and needs, are primarily supported by nine (9) IRS employees in the Exempt Organizations Customer Education and Outreach (CE&O) division of TE/GE.[7] The "research gap" regarding the characteristics

1 Tax Exempt and Government Entities (TE/GE), *Exempt Organizations Annual Report and Fiscal Year 2009 Work Plan* 1 (Nov. 2008) (TE/GE Work Plan), http://www.irs.gov/pub/irs-tege/finalannualrptworkplan11_25_08.pdf (last visited Oct. 14, 2009).

2 The U.S. Census Bureau estimates the resident population of the United States and Puerto Rico as of July 1, 2008, was 304,059,724. Population Division, U.S. Census Bureau, Table 1: Annual Estimates of the Resident Population for the United States, Regions, States, and Puerto Rico: April 1, 2000 to July 1, 2008 (NST_EST2008-01), *available at* http://www.census.gov/popest/states/tables/NST-EST2008-01.xls (last visited Oct. 14, 2009).

3 Amy Blackwood, Kennard T. Wing & Thomas H. Pollak, *The Nonprofit Sector in Brief, Facts and Figures from the Nonprofit Almanac 2008: Public Charities, Giving, and Volunteering*, Urban Institute Table 1 *available at* http://www.urban.org/UploadedPDF/411664_facts_and_figures.pdf (last visited Oct. 14, 2009). "Reporting" nonprofits refers to organizations that were required to report (some churches reported although they were not required to do so); they numbered 530,376 in 2005.

4 TE/GE Work Plan, 1.

5 Steven T. Miller, Commissioner, Tax Exempt and Government Entities, Internal Revenue Service, Remarks Before the Philanthropy Roundtable, "The IRS's Role in an Evolving Charitable Sector" (Nov.10, 2007). The IRS anticipated that in 2008, 36 percent (approximately 650,000) of EOs could be categorized as small entities with gross receipts under $25,000. National Taxpayer Advocate 2007 Annual Report to Congress 206.

6 National Taxpayer Advocate 2007 Annual Report to Congress 204.

7 IRS response to TAS information request (June 23, 2009).

of the EO population, together with this inadequate staffing level, places the IRS in the position of using a one-size-fits-all, Internet-based approach to delivering service and helping exempt organizations understand their reporting responsibilities. The National Taxpayer Advocate is concerned that this strategy does not meet the growing needs of exempt organizations. An EO component of the Taxpayer Assistance Blueprint (TAB) would enable the IRS to articulate the level of service and assistance it currently provides, ascertain the needs and preferences of the tax-exempt population, and develop a plan to close any gaps in service the TAB research identifies.

ANALYSIS OF PROBLEM

Background

Small EOs Constitute the Majority of the Tax-Exempt Sector.

Most nonprofit organizations are public charities.[8] As of 2005, institutions of higher education, hospitals, and primary care facilities, which comprise about two percent of the total number of public charities, held more than half of the assets held by public charities.[9] These large organizations accounted for about 55 percent of all expenses incurred by public charities, with four percent of all public charities accounting for 83 percent of the total expenses.[10] In contrast, most public charities incurred less than $500,000 in expenses; 29 percent reported expenses between $100,000 and $499,999, and 45 percent of public charities, the single biggest category, reported less than $100,000 in expenses.[11] The proportion of expenses incurred by organizations of various sizes is shown in Chart 1.20.1 below.

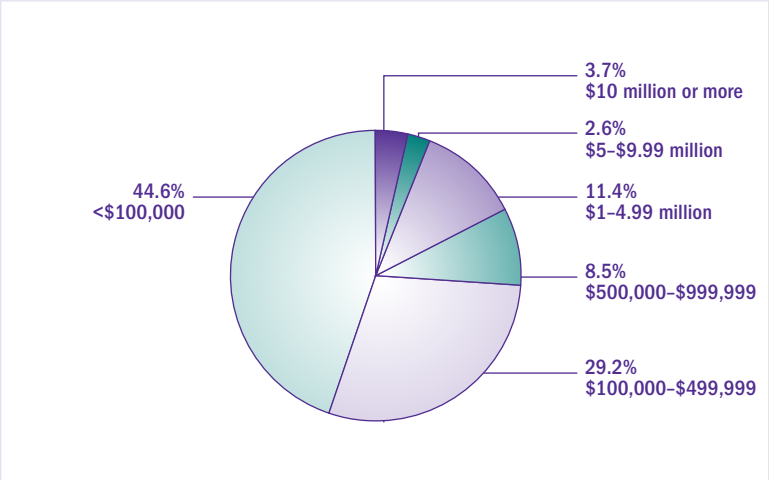
8 Amy Blackwood, Kennard T. Wing & Thomas H. Pollak, *The Nonprofit Sector in Brief, Facts and Figures from the Nonprofit Almanac 2008: Public Charities, Giving, and Volunteering, Urban Institute* Table 1, *available at* http://www.urban.org/UploadedPDF/411664_facts_and_figures.pdf (last visited Oct. 14, 2009). "Nonprofit organizations" include, in addition to public charities, private foundations and other nonprofit organizations such as social and recreational clubs, trade associations, labor unions, veterans associations, and advocacy organizations.

9 *Id.* at Table 2. Institutions of higher education, which constituted 0.7 percent of the total number of reporting public charities, held 21.3 percent of total assets. Hospitals and primary care facilities, which constituted 1.6 percent of the total number of reporting public charities, held 30.8 percent of total assets.

10 *Id.* at Table 2 and Figure 1. Institutions of higher education accounted for 10.4 percent, and hospitals and primary care facilities accounted for 44.4 percent, of total expenses of reporting public charities.

11 *Id.* at Figure 1.

CHART 1.20.1, Percent of Public Charities by Reported Expenses 2005



Many EOs, particularly smaller entities, lack professional accounting staff and rely on volunteer support to manage their interactions with the IRS.[12]

Small Exempt Organizations Are Often Staffed by High-Turnover Volunteers who Lack "Back Room" Expertise.

In early 2005, roughly half of all EOs were staffed entirely by volunteers and another third had fewer than ten employees.[13] From September of 2008 through March 2009, 33 percent of surveyed organizations reported increased reliance on volunteers. More than half of the surveyed organizations dealt with their own fiscal stress by eliminating or decreasing staff positions.[14] These cutbacks often first affect the "back room of the house" (*i.e.*, the administrative functions rather than programming or charitable activities), leaving those duties to be carried out by volunteers.[15] About half of the organizations expected their reliance on volunteers to increase during the remainder of 2009 and a third expected to cut staff in 2009.[16]

The difficulty a volunteer working in the "back room" of a small organization might face is illustrated by the task of determining whether the organization can meet its IRS annual reporting obligations by filing an e-Postcard (discussed below), an alternative available to organizations with gross receipts normally $25,000 or less. The "simplified" language on

12 IRS, TE/GE *FY 2005 Strategic Assessment* 3 (Feb. 2, 2005).

13 *Id.*

14 Lester M. Salamon & Kasey L. Spence, *Volunteers and the Economic Downturn* 1, Johns Hopkins Center for Civil Society Studies Research Brief (July 2009).

15 As Michael Kaiser, president of the John F. Kennedy Center for the Performing Arts advised, "If you start by cutting the programming, rather than everything in the back of the house, you're signing a warrant that everything will just get worse, worse, worse." William Triplett, *Arts Organizations on the Brink Are Turning to Him for Advice*, The Wall Street Journal, D7 (Feb. 19, 2008).

16 Lester M. Salamon & Kasey L. Spence, *Volunteers and the Economic Downturn* 2, Johns Hopkins Center for Civil Society Studies Research Brief (July 2009).

the IRS website explains that an organization's gross receipts will be "considered to be" $25,000 or less if the organization:

- Has been in existence for one year or less and received, or donors have pledged to give, *$37,500* or less during the organization's *first* tax year;
- Has been in existence between one and three years and averaged $30,000 or less in gross receipts during each of its *first two tax years*; or
- Is at least three years old and averaged $25,000 or less in gross receipts for the *immediately preceding three tax years* (including the year for which calculations are being made).[17]

A volunteer who successfully navigates the organization's initial reporting obligations may encounter even more complex issues as the EO pursues its day-to-day operations.[18] Paradoxically, EOs that turn to innovative fundraising activities in response to economic pressure may inadvertently create new reporting challenges such as recognizing potential liability for excise taxes and accounting for unrelated business taxable income.[19]

The noted lack of expertise in accounting and finance in the volunteer cadre, the very areas in which paid professionals (if there were any) are likely to have been cut, might be less of a problem if there were more stability in the volunteer corps. Instead, the EO workforce is characterized by "a dramatic cycling of people in and out of volunteering."[20] The difficulty exempt organizations face in meeting their reporting obligations is further exacerbated when those reporting obligations change.

Exempt Organizations Face New IRS Filing Requirements and Sanctions.

Until recently, some small tax-exempt organizations (*i.e.*, those with annual gross receipts normally of $25,000 or less) did not have IRS reporting requirements. The Pension Protection Act of 2006 now requires these organizations to file Form 990-N, *Electronic Notice (e-Postcard) for Tax-Exempt Organizations not Required to File Form 990 or 990-EZ*.[21]

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17 IRS, *Gross Receipts Normally $25,000 or Less*, at http://www.irs.gov/charities/article/0,,id=177338,00.html (last visited Oct. 14, 2009).

18 For example, tax-exempt status is allowed under IRC § 501(c)(3) for organizations "no part of the net earnings of which inures to the benefit of any private shareholder or individual." The purpose of this provision is to prevent any element of personal gain and to provide tax-exempt status to entities "in which no man receives a scintilla of individual profit." *See* 44 Cong. Rec. S4149 at 4150-4151 (1909) (statement of Sen. Bacon). Its meaning has remained elusive, elastic, and evolutionary." Darryll K. Jones, *The Scintilla of Individual Profit: In Search of Private Inurement and Excess Benefit*, 19 Va. Tax Rev. 575, 678 (2000).

19 IRC § 511 provides for the imposition of tax on a charitable organization's unrelated business taxable income, defined in IRC §§ 512(a)(1) and 513 generally as earnings that derive from a trade or business regularly carried on which is not substantially related to the organization's exempt purposes.

20 Roughly one third of EO volunteers serve for only one year. Research Brief: *Volunteering in America Research Highlights*, Corporation for National & Community Service 5, July 2008, (Research Brief) *available at* http://www.volunteeringinamerica.gov/assets/resources/VIA_Brief_FINAL.pdf (last visited Oct. 14, 2009).

21 Pension Protection Act of 2006, Pub. L. No. 109-280 § 1223, 120 Stat. 780, 1090 (2006); IRC § 6033(i). The e-Postcard consist of an electronic file with 26 fields for information such as the organization's employer identification number, tax year, name, address, tax period, officer name, officer address, etc. Exceptions to the new reporting requirement include churches, their integrated auxiliaries, and conventions or associations of churches.

The first filings came due in 2008, and as of May 14, 2009, approximately 284,000 exempt organizations had filed e-Postcards.[22]

Non-filing by an EO can have community-wide repercussions, in addition to the potential liability for various taxes and penalties. An organization that fails to file the required e-Postcard for three consecutive tax years will automatically lose its tax-exempt status.[23] In that event, the formerly tax-exempt organization will no longer receive tax-deductible donations and will be subject to taxation on its receipts, which could effectively terminate its operations.[24] Additionally, organizations that initially meet their filing requirements by filing an e-Postcard may encounter difficulty as they grow from very small to small, or from small to medium, or as they add a new employee, undertake an additional activity, or obtain a significant grant or other source of funding, all of which may change their reporting requirements.

EO Customer Education and Outreach Staff Continues to Do Much with Few Resources.

Exempt Organization's Customer Education and Outreach spearheads the TE/GE division's proactive efforts to help exempt organizations understand their tax responsibilities. Because the core staff of CE&O consists of only nine full-time employees, CE&O uses experts from elsewhere in EO to provide support and deliver its outreach, educational products, and services.[25] Even taking into account that other parts of the division assist CE&O, CE&O has only 14.2 full time equivalent employees (FTEs).[26] Further, as shown in Chart 1.20.2 below, the number of CE&O employees is very small compared to the number of EO employees, hovering at less than 1.5 percent.

22 E-Postcard filings are publicly available at http://www.irs.gov/app/ePostcard/forwardToDownload.do, which the IRS updates weekly. As of May 14, 2009, 283,924 e-Postcards had been filed. The number of organizations affected by the new e-Postcard filing requirement appears to be a moving target. The IRS initially identified 640,000 potential e-Postcard filers in its database. The IRS revised the expected filing population to approximately 166,000. TE/GE Work Plan, *supra* note 1 at 12. Because of this uncertainty about the number of entities required to file, it is difficult to say whether actual filings represent a compliance success or not.

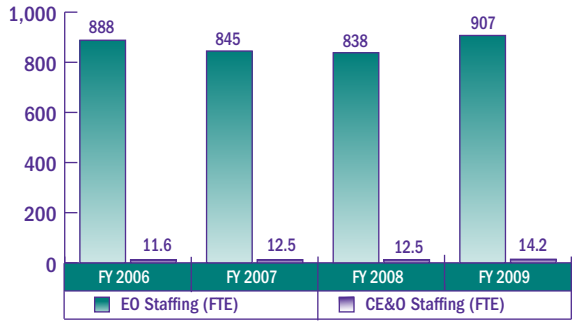
23 IRC § 6033(j).

24 Exempt organizations that already had filing obligations were affected by the revised 2008 IRS Form 990, *Return of Organization Exempt from Income Tax*, to be filed in 2009 and later years. Organizations eligible to file Form 990-EZ were also impacted by changes in filing requirements. IRS, *Overview of Form 990 Redesign for Tax Year 2008*, *available at* http://www.irs.gov/pub/irs-tege/overview__form__990__redesign.pdf (last visited Oct. 14, 2009). Organizations required to file the Form 990 or Form 990 EZ that fail to file for three consecutive years will lose their tax-exempt status. IRC § 6033(j).

25 IRS response to TAS information request (June 23, 2009).

26 *Id.*

CHART 1.20.2, CE&O FTE Staff and EO FTE Staff, FY 2006-2009[27]



Subsequent to a series of recommendations by the National Taxpayer Advocate, CE&O began developing a new initiative to reach out directly to academic institutions that offer degrees related to the non-profit sector.[28] Through the use of existing tools and the possible development of additional resources, CE&O proposes to collaborate with these institutions to promote the education of exempt organization tax law.[29]

We commend CE&O for its willingness to leverage its resources. Nevertheless, the National Taxpayer Advocate remains concerned that the number of CE&O FTEs is 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.[30] While CE&O has done much with few resources, it cannot adequately meet the needs of the tax-exempt sector without better funding. Finally, it is apparent that the practice of allocating many more resources to TE/GE enforcement activities than to CE&O, noted by the National Taxpayer Advocate in the 2005 and 2007 Annual Reports to Congress, continues.[31] Chart 1.20.3 shows the relationship between the CE&O outreach budget, the EO Exam budget, and the remaining EO budget.

27 IRS response to TAS information request (June 23, 2009); IRS Human Resources Reporting Center, Work Force Information by Organization, Sept. 26, 2009, Sept. 26, 2008, Sept. 29, 2007, Sept. 30, 2006.

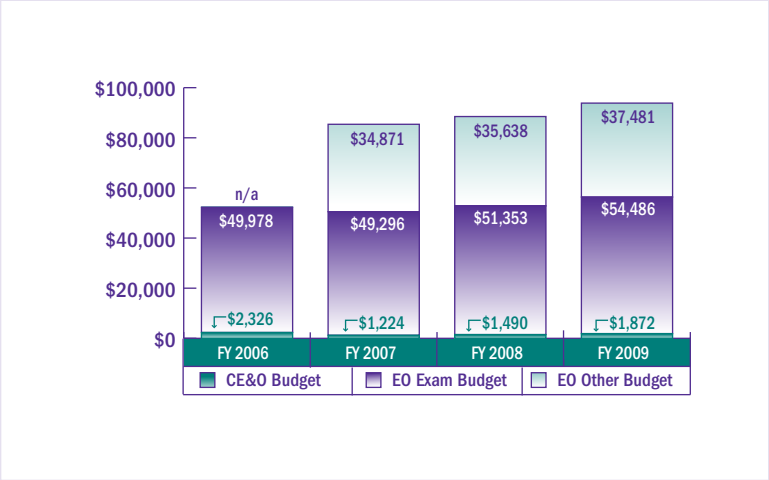
28 Announcement 2009-29, *Request for Public Comments on New Academic Institution Initiative*, IRB 2009-14. *See* National Taxpayer Advocate 2007 Annual Report to Congress 209; National Taxpayer Advocate 2005 Annual Report to Congress 307, 313.

29 Leslie Crutchfield & Heather McLeod Grant, *Forces for Good: The Six Practices of High-Impact Nonprofits*, 40 (2007), published with support from the Aspen Institute Nonprofit Sector Philanthropy Program, describe this type of partnering arrangement as "a great example of getting more bang for your buck."

30 National Taxpayer Advocate 2007 Annual Report to Congress 207.

31 National Taxpayer Advocate 2007 Annual Report to Congress 207; National Taxpayer Advocate 2005 Annual Report to Congress 295. IRS response to TAS information request (June 23, 2009).

CHART 1.20.3, CE&O Budgets Compared to EO Exam Budgets and EO Other Budgets, FY 2006-2009[32]



The budget for EO Exam consistently exceeds 50 percent of the total EO budget and dwarfs the budget for CE&O.

Needs Cannot Be Addressed Until They Are Known.

The National Taxpayer Advocate first recommended in 2007 that the IRS conduct a Taxpayer Assistance Blueprint to study the needs and preferences of EOs by size and type of organization.[33] The purpose of a TAB is to provide a methodology for obtaining comprehensive information about the service needs and preferences of a specific taxpayer population. That data can then form the foundation of a service strategic plan and initiatives, and identify additional research needs.

An EO TAB should first set forth, as a baseline, the current services for the tax-exempt population. The research phase of the TAB should then explore whether there are differences across segments of the EO population, and investigate:

- *Taxpayer needs*

32 IRS response to TAS information request (Sept. 16, 2009).

33 National Taxpayer Advocate 2007 Annual Report to Congress 209. In July 2005, Congress directed the IRS, the IRS Oversight Board, and the National Taxpayer Advocate collaboratively to develop a five year plan for taxpayer service. S. Rep. No. 109-109, 133-34 (2005). The current TAB is overseen by the Wage and Investment division and is focused on individual taxpayers. *See* IRS, *The 2006 Taxpayer Assistance Blueprint: Phase I*, 19, *available at* http://www.irs.gov/pub/irs-pdf/p4525.pdf. The TAB Phase 1 report, delivered to Congress in April 2006, included a baseline of current taxpayer services for individuals and outlined key strategic improvement themes. The TAB Phase 2 report, delivered to Congress in April 2007, included the National Taxpayer Advocate's recommendation, with which the Oversight Board agreed, that the TAB team broaden its focus to include service delivery through TE/GE as well. *See The 2006 Taxpayer Assistance Blueprint: Phase II* at 46, 42. *See also* Most Serious Problems: *The IRS Lacks a Servicewide E-Services Strategy*, *supra*; *Beyond EITC: The Needs of Low Income Taxpayers Are Not Being Adequately Met*, *supra*; *Appeals' Efficiency Initiatives Have Not Improved Taxpayer Satisfaction or Confidence in Appeals*, *supra*; and *IRS Toll-Free Telephone Service is Declining as Taxpayer Demand For Telephone Service Is Increasing*, *supra*.

  - What services are needed by EOs – those that use paid tax preparers, and those that do not?
  - Who should deliver the needed services (the IRS, the preparer, or another entity or association), and how, when, and where should those services be delivered?
  - How well is the IRS meeting the service needs of EOs (*i.e.*, gap analysis)?
  - Is the IRS providing sufficient service capacity to meet EO needs for each service channel?
- *Taxpayer Awareness*
  - Are EOs aware of the services the IRS offers and if not, how can the IRS best inform them?
- *Taxpayer Preferences*
  - What are EOs' preferred channels to receive services (*e.g.*, face to face, by Internet, by telephone, through correspondence), and do their preferences differ based on their size, their purpose, the extent of their volunteer staffing, their location as rural or urban, and the type of service?
  - How does EO preference change based on how the service is delivered (*e.g.*, hours of availability of the service, wait time for the service, accuracy of the service, probability of first contact resolution)?
  - Is the IRS delivering services in the ways the EOs prefer to receive them?
- *Taxpayer Use*
  - Can EOs effectively use services as they are currently being delivered? If not, what are the barriers to effective service use?
  - Are EOs satisfied with the services they use?

With this information, the IRS could identify gaps in its current services. From there, the IRS could design a specific plan to address the needs identified, and provide assistance, outreach, and support designed to meet the needs and preferences of specific segments of the tax-exempt population, paying special attention to the educational needs of small and newly formed organizations. With this plan in place, the IRS could begin to simultaneously measure the effectiveness of current outreach and education efforts (beyond measuring numbers of customers reached), and the effect these efforts have on compliance.

IRS Needs Local Collaboration.

It would be effective to position EO employees at the local as well as at the national level. The IRS has long recognized the effectiveness of this approach; the Taxpayer Education and Communications (TEC) organization is an example

of this type of initiative.[34] Although the IRS later departed from the promising TEC model in SB/SE, this type of cooperative effort remains in place within the Wage and Investment (W&I) operating division.[35] W&I's 590 Stakeholder Partnerships, Education, and Communication (SPEC) employees are designated as points of contact for specific local as well as national stakeholders and organizations.[36] TE/GE would benefit from a similar structure and increased staffing. A local presence would increase the effectiveness of CE&O workshops and outreach efforts by expanding their reach beyond major cities. Based on the data provided by a TE/GE Blueprint, TE/GE could target its workshops to meet identified needs, and tailor the workshops or other outreach activities accordingly.

CONCLUSION

In conclusion, we recommend that the IRS design and implement an EO Taxpayer Assistance Blueprint in order to formulate a targeted outreach plan based on research. The IRS should also identify collaborative partners to deliver the plan, and use data generated by the TAB to make a compelling argument for appropriate levels of funding for outreach, education, and a local CE&O presence.

IRS COMMENTS

The IRS recognizes that some small exempt organizations may encounter difficulty in meeting their obligations, which is why we have developed a myriad of materials specifically to help these organizations understand their responsibilities. Although most of our materials are accessible via the *Charities and Nonprofits* web pages of IRS.gov, many resources and services are available in print or 'in person.' For example:

- 'Face-to-face' events:
  - Small and Midsize (SMS) Workshop Program: CE&O offers one-day workshops for representatives of small and mid-sized IRC § 501(c)(3) organizations in cities around the country. The workshops, which attract nonprofit paid employees, volunteers, and tax professionals serving nonprofit clients, feature an in-depth discussion of the benefits and responsibilities of tax- exempt status and actions that could jeopardize that status.

[34] TEC was created as part of the Small Business/Self Employed (SB/SE) division following the Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, §1001, 112 Stat. 685, 689 (1998). TEC was to advance its education and outreach programs through partnerships with government agencies, small business organizations, tax practitioner groups, and other stakeholders. The IRS planned to start TEC with approximately 329 employees in FY 2001 and increase staffing incrementally. By FY 2002, TEC was to have over 1,200 staff in 15 major field locations and an annual budget of $60 million. *See* National Taxpayer Advocate 2006 Annual Report to Congress 175-78.

[35] The IRS merged TEC into other outreach and communication units in the SB/SE division in 2005, and ultimately replaced TEC with the Stakeholder Liaison unit. As of December 2005, the Stakeholder Liaison unit consisted of 174 employees in the field and 34 in headquarters. As of May 2009, the Stakeholder Liaison unit consisted of 167 employees in the field and 31 in headquarters. *See* IRS Human Resources Reporting Center, Organizational Location Reports, http://persinfo.web.irs.gov/track/workorg.asp (last visited Oct. 14, 2009).

[36] *See* IRS Human Resources Reporting Center, Organizational Location Reports, http://persinfo.web.irs.gov/track/workorg.asp (last visited Oct. 14, 2009).

- Speeches: IRS Exempt Organization specialists make presentations before audiences of tax-exempt organizations. Most of these presentations are in-person; however, some are delivered via phone forums or webinars, depending on the needs of the audience.
- Tax Forums: EO plays a significant role at the IRS Nationwide Tax Forums. For example, in 2009, Exempt Organizations offered a 50-minute seminar, *Weathering the Storm: Helping Exempt Organizations in Troubled Times,* which provided an overview of the issues confronting exempt organizations in light of the current economic climate. In addition, EO presented a two-hour workshop: *Redesigned Form 990 Information Return*, multiple times at each of the six Forums.
- Call site: Although under W&I, the TE/GE toll-free operation continues to respond to questions from tax-exempt organizations. In FY 2009, over one-half million calls were answered.

- Plain language publications: EO has developed a series of plain-language publications specifically for the non-professional tax-exempt audience. Examples include *Applying for Tax-Exempt Status* (Publication 4220); *Compliance Guide for 501(c)(3) Public Charities* (Publication 4221-PC); and *The NEW e-Postcard (Form 990-N): What Smaller Organizations Need to Know to Stay Tax-Exempt* (Publication 4752). Publications are available in paper and on the web.
- Web – based materials:
  - StayExempt.irs.gov: To expand the reach of the SMS Workshop Program to organizations unable to attend, or as reinforcement to those that did attend, CE&O developed an interactive web-based version of the one-day program, www.StayExempt.irs.gov.
  - Mini-courses: CE&O developed 15 mini-courses on various topics of interest to exempt organizations including such topics as: *An Overview of Form 990-EZ; Applying for Tax-exempt Status; Can I Deduct My Charitable Contribution?;* and *Disaster Relief* (parts 1 and 2).
  - Life Cycles of an Exempt Organization: These six web-based information tools (for various types of exempt organizations, including public charities), link to explanatory information and provide a graphical snapshot of five stages exempt organizations typically go through: starting out, applying for exemption, filing requirements, on-going compliance issues, and significant events.
  - ABC's for EOs: This resource page is intended for managers of new and small tax-exempt organizations.

Research

The National Taxpayer Advocate asserts that, without conducting a Taxpayer Assistance Blueprint, the IRS has no methodology to obtain comprehensive information about the services EOs need from the IRS or the manner in which they prefer to receive them.

Although the IRS has not conducted a TAB for exempt organizations, during the past year CE&O has reached out to the sector to seek its input and plans to continue to do so in the coming year.

Through our project to improve the *Charities and Nonprofits* pages of IRS.gov, we have:

- Sought input, comments and suggestions from the public through an announcement in the Internal Revenue Bulletin and in the *EO Update*, Exempt Organization's on-line subscription newsletter;
- Conducted focus groups at the Nationwide Tax Forums (as recommended by the National Taxpayer Advocate's 2007 Annual Report to Congress); and
- Conducted contextual interviews with state charity officials, educators, researchers, tax practitioners, and volunteers.

Through these communication efforts, we posed questions intended to help us understand preferred information products, design, and delivery channels. For example, the contextual interviews explored:

- How the *Charities and Nonprofit* web-users look for and use information;
- What do our customers come to the IRS to do;
- How should the *Charities and Nonprofit* pages be structured to meet their needs; and
- What information/products do our web-users expect from the IRS.

The feedback received from these focus groups and interviews is currently being collated and evaluated.

In the coming year, we will expand this information gathering process by working with an experienced communications firm under contract with the IRS. We have asked the firm to study the communications needs and preferences of tax-exempt organizations and to help us develop a multi-year strategy that will:

- Assess the needs and preferences of tax-exempt organizations for outreach and education;
- Develop improved outreach and education services; and
- Recommend ways to raise awareness and increase usage of EO education and outreach services and programs.

Working with EO, the firm will develop a three-year communications and marketing plan designed to use the most effective and efficient way to reach the tax-exempt community.

EO CE&O Continues to Do Much with Few Resources

The Exempt Organization's Customer Education and Outreach plays an important role in the IRS, and is a valuable part of EO. As the National Taxpayer Advocate acknowledges, CE&O continues to accomplish much with its small number of resources. CE&O continues to explore new ways of leveraging existing IRS resources and developing new external resources to carry out its mission of helping tax-exempt organizations.

For example, in the past year, CE&O enlisted the help of the Field Media branch to promote our SMS Workshops. Using their local contacts with the media and charitable organizations, Field Media communicators helped CE&O increase workshop attendance.

In addition, CE&O's new Academic Institution Initiative, mentioned by the National Taxpayer Advocate, will leverage our resources by partnering with educational entities that work to develop, cultivate, and promote professionals who shape the non-profit sector. Our goal is to help prepare the non-profit leaders of the future by familiarizing them with the federal tax laws. A September kickoff meeting generated a substantial number of helpful ideas from educational institutions, including the following, which we will adopt in 2010:

- Consult with institution representatives to determine gaps in our materials and feedback on our websites;
- Work with universities to co-sponsor additional sessions of our Small and Mid-size Workshop Program;
- Identify and collaborate with existing educational networks, such as the National Association of Schools of Public Affairs and Administration (NASPAA) and the National Academic Centers Council (NACC); and
- Develop an 'Educators' page on the Charities and Non-Profits pages of IRS.gov.

In conclusion, the IRS is committed to meeting the needs of the exempt organization community as reflected by the significant number and types of services and products currently being provided, and will continue to explore ways to improve and increase these services and products.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS recognizes the need to expand its information gathering process and intends to retain a communications firm to assist with this endeavor. She congratulates CE&O for continuing to pursue its Academic Institution Initiative, and hopes that CE&O representatives will talk directly with the students at the partnering institutions, so that this outreach program will help build a local presence. However, she remains concerned that the multi-year strategy EO expects to develop will lack the scope and rigor of a TE/GE Taxpayer Assistance Blueprint. The National Taxpayer Advocate believes that rather than attempting to understand the needs of exempt organizations in an ad-hoc or piecemeal manner, a comprehensive approach, supported by research and propelled by adequate funding, is critical if the IRS is to meet the most needs in a cost-effective and efficient manner. The National Taxpayer Advocate challenges the IRS to carry out its stated intention of fulfilling the needs of the exempt organization community by designing and implementing a TE/GE Taxpayer Assistance Blueprint and achieving adequate staffing levels for its education and outreach functions.

Recommendations

The National Taxpayer Advocate recommends that the IRS take the following specific actions to meet the needs of exempt organizations.

1. Design and implement an EO Taxpayer Assistance Blueprint to formulate a targeted outreach plan based on research.
2. Use data generated by the TAB to present a compelling argument for appropriate levels of funding for outreach, education, and a local CE&O presence.

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

RESPONSIBLE OFFICIAL

Patricia McGuire, Acting, Director Research, Analysis, and Statistics

DEFINITION OF PROBLEM

Testing and marketing products, and studying behavioral reactions to programs, processes, and information, is standard practice in private industry and is not unheard of among government agencies in the United States and abroad. The IRS recognizes the advantages of testing products prior to release, as demonstrated by the project underway with the Taxpayer Communications Taskgroup (TACT) to test taxpayers' responses and reactions to notices, as well as other IRS efforts. In previous Annual Reports to Congress, the National Taxpayer Advocate has recommended that the IRS establish an in-house cognitive research lab.[1] A cognitive lab could test IRS products, programs, and assumptions prior to releasing notices, forms, or educational products to the public, or before embarking on new programs and changing processes or procedures that affect the ways in which the IRS interacts with taxpayers. Despite these recommendations, the IRS has not been receptive to creating an in-house cognitive research lab.

ANALYSIS OF PROBLEM

Creating a cognitive research lab for a tax agency is not a novel idea. The United Kingdom already has a similar lab in Her Majesty's Revenue and Customs (HMRC) to analyze taxpayer behavior and promote compliance.[2] Through such a lab, the IRS could focus on particular taxpayer populations and gain insight into how those taxpayers behave when presented with IRS actions. All IRS operating divisions would benefit from the creation of a cognitive research lab due to testing the varied products, programs, and processes in place or being proposed, and with respect to services, compliance, or enforcement initiatives. These could be tested and studied by a team of sociologists, psychologists, educators, ethicists, and other professionals.

1 *See, e.g.*, 2008 National Taxpayer Advocate Annual Report to Congress 175; 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. 2, 161.

2 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. 2, 159.

An in-house cognitive research lab would benefit the IRS both in product testing and behavioral research. The IRS could test products, programs, and initiatives ranging from local compliance initiatives to new forms. Such studies would allow the IRS to determine what motivates taxpayers to pay their taxes and how new products or programs affect compliance. While the IRS has researched some factors that influence taxpayer compliance behavior, the IRS still lacks a comprehensive understanding of what motivates taxpayers to comply with their tax obligations, how compliance motivators vary between different taxpayer segments, and how well taxpayers understand instructions and tax concepts.

Further, the IRS does not test its assumptions when deciding what approaches to use for different populations or varying tax situations. Although the IRS conducts numerous surveys to identify preferences, it does not validate those preferences, even though a taxpayer may behave very differently once he or she is actually experiencing a given situation. The knowledge gained from studying taxpayer behavior in a cognitive research lab could have a significant impact on downstream costs. Not only would comprehensive behavioral research permit the IRS to study taxpayer reactions to products, processes, and programs, but it could also test assumptions as to why taxpayers comply, or do not comply, with their tax obligations, and whether adjusting those assumptions would promote greater compliance. Such an upfront investment in the behavioral aspects of tax compliance, in addition to the ability to test products and programs before releasing them to the public, could save rework when the IRS discovers that a process, procedure, program, or notice confuses taxpayers or even drives them into noncompliance.

Taxpayer Motivators and Behavioral Responses

The IRS does not know what motivates some taxpayers to pay their taxes while others fail to comply with their obligations, nor does it understand how taxpayers comprehend instructions related to taxes. The Taxpayer Advocate Service commissioned a study to examine the question of tax morale and how it affects compliance, but the IRS needs to know much more about motivators across taxpaying demographics.[3] Taxpayers are not a unified population and differ in what they require from the IRS to comply with their obligations, yet the IRS does not study how various groups perceive, understand, react, and respond to tax initiatives, programs, and products.[4] Failure to study the understanding and behavioral consequences of IRS actions leads the IRS to proceed with actions without examining the downstream consequences on taxpayer populations.

[3] 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. 2, 138-80.

[4] Multiple sources, including the IRS Oversight Board, the National Taxpayer Advocate, and the Government Accountability Office have strongly urged the IRS to conduct these studies. *See, e.g.*, IRS Oversight Board, *Taxpayer Customer Service and Channel Preference Survey Special Report* (Nov. 2006); National Taxpayer Advocate 2006 Annual Report to Congress vol. 2, 1-15, *Study of Taxpayers Needs, Preferences, and Willingness to Use IRS Services.*

Ongoing Efforts

Taxpayer Communications Taskgroup

The IRS acknowledges the utility of testing products in limited situations. The TACT is working with a contractor, Siegal and Gale, to reduce the complexity of notices. The contractor uses a "Simplicity Lab," an online testing module, where taxpayers participate in evaluating different notices. The contractor has tested the IRS's CP2000, CP521, and L-1058 notices and used the results to assist the TACT in modifying and retesting them.[5] This is an excellent first step, although taxpayers must have Internet access and be Internet-savvy to complete the evaluation. This process fails to involve taxpayers who might not be knowledgeable about the Internet and may be in greater need of simplified notices. However, the IRS is moving in the direction of testing notices with taxpayers prior to release to the public, which is a commendable first step.

Ogden Usability Lab

The IRS has a Usability Lab at the Ogden Campus, which the operating divisions can use in several ways to test products. The lab has an observation room where employees can observe participants as they work with a notice, website, or other product, and the lab can broadcast the test over the IRS intranet so employees in remote locations can also observe testing. The lab tests products on both IRS employees and taxpayers. Many tests involve the IRS intranet or software that operating divisions may roll out for employee use, but the lab also tests notices and the external IRS website (IRS.gov). The lab provides data analysis, project planning, and prototyping as part of its services.

National Taxpayer Advocate Publication One Project

The National Taxpayer Advocate, in conjunction with IRS Forms and Publications, is working to develop a revised Publication 1 (Pub 1), *Your Rights as a Taxpayer*. Pub 1 explains basic taxpayer rights and provides taxpayers with general information about the exam process, collection, appeals, innocent spouse, refunds, and third party contact.[6] The purpose of this project is to test variations of Pub 1 on taxpayers before they enter into discussions with the IRS regarding tax issues. For example, a taxpayer facing an examination or audit issue would be given a test version of Pub 1 and a "control" taxpayer facing a similar situation would be given the current publication. After both taxpayers have been given the chance to read Pub 1, they would be questioned to see who has a better understanding of his or her rights in an audit. After analyzing the results, the test version of Pub 1 would be altered and retested to see if additional changes make taxpayers more aware of their rights.

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5 IRS, Simplicity Laboratory Evaluation of Original and Revised IRS Forms CP521, L-1058, and CP2000, February, 2009. The CP2000 notice is issued to taxpayers to request verification for unreported income, payments, or credits. The CP521 is the installment agreement reminder notice. The L-1058 notice informs taxpayers their assets will be seized due to overdue taxes.

6 IRS, Pub. 1, *Your Rights as a Taxpayer* (May 2005). Pub. 1 fulfills the statutory requirement under Internal Revenue Code (IRC) §7521(b)(1) that the IRS provide an explanation of the taxpayer's rights and the audit process or the collection process in conjunction with an initial in-person taxpayer interview.

In conjunction with this project, the National Taxpayer Advocate also intends to test taxpayers' understanding of the Taxpayer Bill of Rights (TBOR).[7] This testing is designed to determine if TBOR resonates with taxpayers, including a statement of a taxpayer's obligations to the tax system. Would a taxpayer who receives a clear statement of obligations cooperate more in an audit? Do taxpayers understand what is expected of them and what rights they have? Does this understanding yield greater compliance?

Building a Lab

The IRS must carefully consider the composition of the in-house Cognitive Research Lab. The right mix of staffing is crucial to the success of any current testing and for developing future testing. Lab personnel would be tasked with keeping abreast of cognitive research conducted in non-tax fields in order to advise the operating divisions how such developments could apply to the IRS. Additionally, the lab personnel could consult on design of new initiatives with the operating divisions, using the knowledge gained from testing in other fields, as well as conducting in-house testing.

The IRS must also develop resources from within. Investing in current employees shows a commitment to the Workforce of Tomorrow initiative.[8] Educating current employees in fields the IRS deems important to its mission is not a new concept, as the IRS has previously developed and staffed new departments wholly from within by investing in the education of employees. In the 1980s, when the IRS created an Artificial Intelligence (AI) program, each Assistant Commissioner selected a mid-career employee to participate, and the employees enrolled in a two-year program at universities such as the University of Pennsylvania and the Massachusetts Institute of Technology. In exchange, the employees agreed to work for the AI program for at least a year before returning to their respective operating divisions, and to work for the IRS for three years for each year of schooling. The IRS paid full tuitions, full salary, and a *per diem* to all employees while they attended the program. In theory, the employees would work in the AI lab and then return to their operating divisions to implement the knowledge they gained.[9]

What Can the IRS Use the Lab For?

In short: everything. The TACT group has already shown how lab testing can benefit the notice development process. The Ogden Usability Lab demonstrates the value of testing websites and many other products. The IRS could also use the cognitive research lab for local compliance initiatives, educational programs, enforcement initiatives, and public information campaigns. The IRS could test whether an implemented program is achieving its purpose or is having unintended consequences. The possibilities of what the lab could study are endless, and insights into what motivates different taxpayers to comply with

7 See National Taxpayer Advocate 2007 Annual Report to Congress 478-89, *Taxpayer Bill of Rights and De Minimis 'Apology' Payments*.

8 See Workforce of Tomorrow, *available at* http://workforceoftomorrow.web.irs.gov/default.aspx (last visited Oct. 9, 2009).

9 Interview with participant Tom Beers (Oct. 9, 2009).

the tax code or helps them understand their rights and obligations would make the lab an invaluable resource. Additionally, the creation of a cognitive learning lab commits the IRS to conducting much-needed research into taxpayer behaviors and motivators and would ensure continuity of research as each study would build off previously completed work.

Challenges to Implementation

Funding a lab will be a significant challenge. The staffers required to build a successful lab are not traditional tax administration employees. Selecting and developing the right mix of candidates from within or hiring qualified external candidates will take time and resources. However, the benefits of in-depth study of taxpayers, their behaviors and motivators, will far outweigh any initial costs and time expenditures. The IRS has shown its willingness to invest in internal research labs in the past, and now should do so permanently by creating an in-house cognitive research lab.

Consequences of Inaction

The benefits of a cognitive research lab are manifold. A lab provides the immediate ability to test the effectiveness of an enforcement initiative or a notice. A lab also provides the long-term benefit of studying the behavior of taxpayers regarding that enforcement initiative or notice, providing the IRS with knowledge to develop a more complete picture of taxpayer segments. Such a depth of knowledge would allow the IRS to effectively design programs, initiatives, and notices from the beginning, with the understanding of how a taxpayer population would probably react to the proposed action. Without the benefit of a lab, the IRS will continue to release products, programs, and initiatives without having tested the methods or assumptions made in developing them to determine if the approach is truly effective.

CONCLUSION

In conclusion, the National Taxpayer Advocate offers these preliminary recommendations:

- National Headquarters Research should study cognitive labs such as HMRC's tax lab to determine how best to structure an IRS lab;
- Identify IRS employees who could be trained to staff the lab;
- Hire staff that cannot be developed rapidly from current IRS employees; and
- Build a cognitive research lab.

IRS COMMENTS

The IRS has for many years been committed to researching taxpayer comprehension, preferences, and barriers to full and timely compliance. This research has improved our forms, communications, services, and procedures, and will continue to do so. Research, Analysis, and Statistics will explore, in consultation with the affected business units, if any of these activities would thrive better under a different structure. As described above, the IRS has a Usability Lab at the Ogden Campus, which the operating divisions can use in several ways to test products. The Usability Lab is currently located in Modernization & Information Technology Services (MITS) and we will assess where to place this Lab, including the Research environment.

The desire to understand what drives taxpayer behavior (particularly compliance behavior) is crucial to effective tax administration. Generally, the factors that drive compliance behavior can be placed into one of two categories: (1) factors that are external to taxpayers (such as socio-economic trends and direct or indirect interactions with the IRS); and (2) factors that are internal to taxpayers (such as perceptions, motives, values, and fears). In our November 2008 report to Congress on *The Factors That Influence Taxpayer Compliance Behavior*, written jointly with the National Taxpayer Advocate, we clarified that the Office of Research, Analysis, and Statistics is taking the lead on research into the linkage between external factors and taxpayer compliance, and that the National Taxpayer Advocate is taking the lead on research into the internal drivers of compliance behavior. To research the impact of external factors, we are conducting lab experiments, field experiments, and statistical analyses of historical data and do not recommend establishing a "cognitive research lab" for this purpose. Our understanding is that HMRC abandoned its idea of forming what it called a "behavioral science unit." Instead, it established a joint venture among several business units called a "Customer Understanding Team," which fosters research similar to what IRS is already doing.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS intends to assess the location of the Usability Lab and to consider placing it in Headquarters Research. Having the Lab located in Research would allow for the expansion of the work the Lab conducts and be a step towards having a comprehensive in-house Cognitive Research Laboratory. However, the National Taxpayer Advocate strongly encourages the IRS to reconsider its position on creating a fully staffed, in-house Cognitive Research Lab. While lab experiments, field experiments, and statistical analysis are all necessary, the National Taxpayer Advocate believes that without using professionals such as psychologists and sociologists to analyze taxpayer behavior, the IRS will not achieve a comprehensive understanding of what motivates taxpayers to comply with their tax obligations, how compliance motivators vary between different taxpayer segments, and how well taxpayers understand instructions and tax concepts.

Additionally, while the National Taxpayer Advocate fully supports and is taking the lead on research into the internal drivers of compliance behavior in relation to the study detailed in *The Factors That Influence Taxpayer Compliance Behavior*, this involvement is not meant to supplant the need for the IRS to conduct future research in this field on its own. Instead, the National Taxpayer Advocate intends to further demonstrate the need for continuing studies into cognitive factors driving taxpayer compliance and the need for a commitment from the IRS to future studies on this subject.

Recommendations

1. National Headquarters Research, along with representatives from the operating Divisions, and TAS, should study cognitive labs to determine how best to structure an IRS lab;
2. Identify IRS employees who could be trained to staff the lab;
3. Hire staff that cannot be developed rapidly from current IRS employees; and
4. Build a cognitive research lab.

Status Update: IRS's Identity Theft Procedures Require Fine-Tuning

RESPONSIBLE OFFICIALS

Richard E. Byrd Jr., Commissioner, Wage and Investment Division
Deborah G. Wolf, Director, Office of Privacy, Information Protection and Data Security

DEFINITION OF PROBLEM

Identity theft occurs in tax administration when an individual intentionally uses the Social Security number (SSN) of another person to file a false tax return or fraudulently gain employment. When these types of identity theft occur, the victim often begins a journey through IRS processes and procedures that may take years to complete. In four of the past five years, the National Taxpayer Advocate has included identity theft as a most serious problem encountered by taxpayers in her annual report to Congress.[1]

RECENT IMPROVEMENTS BY THE IRS TO IDENTITY THEFT PROCESSES AND PROCEDURES

The National Taxpayer Advocate applauds the IRS's recent improvements in procedures to assist victims of identity theft. In January 2008, the IRS began marking the accounts of victims with an electronic indicator if the victims provide the appropriate documentation of identity theft (a copy of a police report or identity theft affidavit, plus photo identification).[2] This identity theft marker (known as the "TC 971" indicator) allows the IRS to track the number of affected taxpayer accounts. The marker was designed to protect federal revenue threatened by identity theft. When applied properly, it also reduces taxpayer burden.

In January 2009, the IRS began to apply a series of filters known as "business rules" to any return filed with an SSN associated with a marked account.[3] Business rules give the IRS an automated means of distinguishing valid returns from fraudulent ones, and are designed to block the processing of fraudulent returns while allowing the IRS to continue to process legitimate returns.

Most significantly, the IRS has established a centralized unit dedicated to assisting identity theft victims. The Identity Protection Specialized Unit (IPSU) became operational on September 29, 2008. Identity theft victims can call a toll-free hotline (800-908-4490) to report their problems, obtain information, and take steps to protect their accounts.[4]

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1 *See* National Taxpayer Advocate 2008 Annual Report to Congress 79-94; National Taxpayer Advocate 2007 Annual Report to Congress 96-115; National Taxpayer Advocate 2005 Annual Report to Congress 180-91; National Taxpayer Advocate 2004 Annual Report to Congress 133-36.

2 IRS, Privacy, Information Protection & Data Security, PIPDS-10-1008-02, *Implementation of Three New Identity Theft Tracking Indicators* (Sept. 29, 2009).

3 Internal Revenue Manual (IRM) 3.12.179.43.1 (Mar. 13, 2009).

4 IRS Tax Tip 2009-11, *Ten Things the IRS Wants You to Know About Identity Theft*, at http://www.irs.gov/newsroom/article/0,,id=202865,00.html (last visited Oct. 14, 2009).

The IPSU provides two essential services to identity theft victims. First, it serves as a central point of contact that interacts with other parts of the IRS as appropriate. Second, the unit conducts a global account review to identify all federal tax issues related to the identity theft and ensures that the responsible IRS functions have taken the appropriate actions to resolve the victim's tax account issues.[5]

DESPITE PROGRAM IMPROVEMENTS, THE IRS CONTINUES TO FACE CHALLENGES

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

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

The IRS Needs to Improve Procedures to Process Tax Returns Rejected by the Business Rules.

As mentioned above, any return filed with an SSN associated with the identity theft indicator is subjected to a set of business rules. The IRS rejected approximately 18,500 returns that did not pass the business rules in 2009.[6] These returns were not allowed to post to the taxpayers' accounts (these are called "unpostable" returns) until the IRS could review the returns and accounts, and determine that they belonged to the valid SSN owners. The IRS did not anticipate such a high volume of returns failing the business rules and had to revise Internal Revenue Manual (IRM) instructions to employees midway through the 2009 filing season to resolve these accounts in a timely fashion.[7]

The IRS estimates that approximately 2,600 unpostable returns were attributable to identity theft and the application of the business rules prevented more than $13.2 million in fraudulent refunds from being issued in 2009.[8] However, the unpostable process also affected many legitimate taxpayers. Approximately 14,000 taxpayers (representing $46.9 million in refunds) were subject to a delay in receiving their refunds during the verification process.[9]

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5 *See* Servicewide Electronic Research Project (SERP) Alert IMF 090190, *Global Review to Be Completed* (Apr. 6, 2009); IRS Tax Tip 2009-11, *Ten Things the IRS Wants You to Know About Identity Theft*, at http://www.irs.gov/newsroom/article/0,,id=202865,00.html (last visited Oct. 14, 2009); Pub. 4535, *Identity Theft Prevention and Victim Assistance* (Oct. 2008).

6 This data was provided by the Identity Theft and Incident Management Office on September 8, 2009 (on file with TAS).

7 IRM 3.12.179.43.1 (Mar. 13, 2009).

8 Data provided by the Identity Theft and Incident Management Office on September 8, 2009 (on file with TAS).

9 *Id.*

The business rules are intended to prevent fraudulent refund claims from being paid, but it is clear that the rules affect too many legitimate taxpayers and need further revision. The National Taxpayer Advocate recognizes that 2009 is the first year the IRS has applied the business rules and that future applications should be incrementally more precise. We urge the IRS to devote the necessary resources to analyzing its data and revising the business rules.

The IRS is also considering the use of a personal identification number (PIN) system to mitigate the unpostable problem. After the IRS substantiates the identity of the taxpayer claiming to be a victim of identity theft, it plans to send that taxpayer a letter containing a PIN, with instructions for the taxpayer to write this PIN on the following year's tax return. If the taxpayer uses this PIN, the IRS will process the return without delay. If a return is filed without this PIN on an account containing an identity theft marker, the return will be processed according to the business rules.[10]

Global Account Review to Be Completed on All Identity Theft Cases

In her 2008 Annual Report, the National Taxpayer Advocate called for a global account review and monitoring for all identity theft victims who come to the IRS.[11] In April 2009, the IRS released guidance indicating that the IPSU will review all accounts where the identity theft marker was applied.[12] We applaud the IRS for adopting these procedures that will benefit identity theft victims.

Under current procedures, a global account review is to take place after the monitoring forms are returned to the IPSU from the function that made the account adjustment.[13] We feel that it is necessary to conduct a preliminary analysis of the account on the front end, in addition to the back-end global review. The IPSU should identify all issues associated with the identity theft and develop a plan of action upon receipt of an identity theft case. After the IPSU conducts its preliminary analysis of the account, it should refer the case to the appropriate IRS function(s) to take the necessary actions to resolve the issue(s). Once all actions are complete, the function(s) should notify the IPSU.

Accounts Management Should Sufficiently Staff the IPSU to Accommodate the Increasing Volume of Identity Theft Cases.

In prior Reports to Congress, the National Taxpayer Advocate noted that the IPSU should be able to handle most of the identity theft cases that TAS currently handles, and TAS

10 The Taxpayer Advocacy Panel (TAP) proposed an alternate recommendation: that individuals be given an option to notify the IRS of their desire to block the use of their SSNs. Once the IRS has received such a notice, it would notify the individual the action has been taken and provide instructions on how to unblock the number before filing a return. *See* TAP recommendation 409-4210, *Identity Theft Suspension of Return Processing* (Apr. 23, 2009).

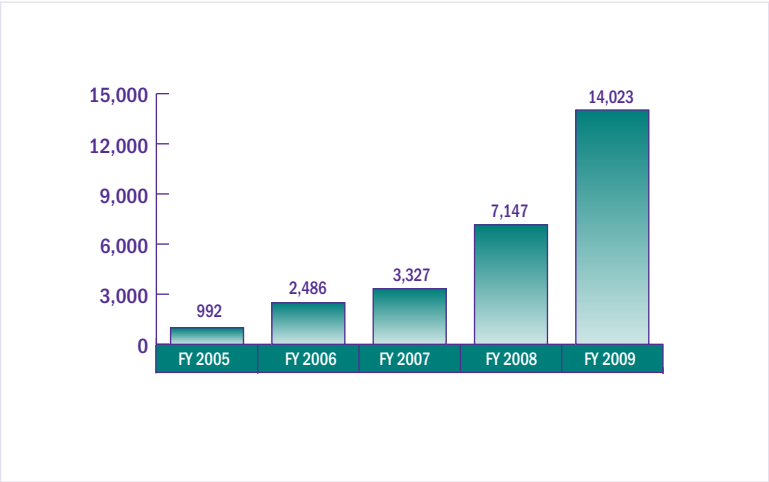
11 *See* National Taxpayer Advocate 2008 Annual Report to Congress 82-83.

12 *See* SERP Alert IMF 09190, *Global Review to Be Completed* (Apr. 6, 2009).

13 *See* IRM 21.9.2.7 (Oct. 1, 2009). IRM 21.9.2.7.2(4) provides that the IPSU "ensure all issues identified have been addressed by the responsible Function."

identity theft cases should be few and far between in the years to come.[14] Surprisingly, the number of TAS stolen identity cases has increased significantly since the IPSU was established. In fiscal year 2009, TAS experienced a 96 percent increase over the previous year in case receipts where stolen identity was the primary issue.

FIGURE 1.22.1, TAS Stolen Identity Case Receipts, FY 2005 - FY 2009[15]



The reasons for the significant increase in TAS identity theft cases are unclear. It may be that there are simply that many more incidents of identity theft than in prior years. It is possible that the increase in TAS cases is a result of earlier outreach that has come to fruition.[16] Perhaps the IRS has not conducted enough outreach to the public about the newly-created IPSU, or has not provided sufficient training to its employees about referring identity theft cases to the IPSU.[17] It is also likely that IRS procedures for the IPSU are not yet sufficient to meet taxpayer needs.

IRS leadership has committed to having the IPSU work identity theft cases once the IPSU has established procedures to resolve them. In general, the IPSU will handle the systemic burden cases (TAS case criteria 5-7), while TAS will continue to assist identity theft victims

14 *See* National Taxpayer Advocate FY 2010 Objectives Report to Congress 34; National Taxpayer Advocate 2008 Annual Report to Congress 94.

15 This chart reflects all TAS cases coded with primary issue code 425 (Stolen Identity).

16 For example, in 2006, the Federal Trade Commission (FTC), the lead federal agency responsible for combating identity theft, published a brochure advising identity theft victims with unresolved tax issues to contact TAS. *See* FTC, *Take Charge: Fighting Back Against Identity Theft* 24 (Feb. 2006), *available at* http://www.ftc.gov/bcp/edu/pubs/consumer/idtheft/idt04.pdf. Until the FTC updates its brochure, some identity theft victims may continue to contact TAS, rather than the IPSU, when they have an unresolved tax issue.

17 TAS analyzed a random sample of stolen identity cases it received in FY 2009. Over 93 percent of these cases were referrals to TAS from the Wage and Investment (W&I) operating division.

who have an economic burden.[18] In addition, TAS will continue to work any systemic burden cases that require advocacy on behalf of the taxpayer, such as those presenting novel issues or where IRS systems continue to fail, which might lead to the issuance of a Taxpayer Assistance Order.

The National Taxpayer Advocate is very pleased that the IPSU will now conduct a global account review on all identity theft cases and work cases currently in TAS inventory. However, she remains concerned that the IRS may not adequately staff the specialized unit. Many identity theft cases involve complex issues and multiple tax years. As a result, the IRS needs to properly staff and train its IPSU employees to handle these complicated cases in a timely manner.

We believe that the IPSU should follow the staffing model that TAS has adopted. TAS uses intake advocates to accept initial calls, develop the facts, identify issues, gather supporting documentation, and conduct a preliminary review of the taxpayer's account. Once the intake is complete, TAS transfers the cases to case advocates who develop plans of action and take steps to resolve the taxpayers' problems. The National Taxpayer Advocate believes that with this division of tasks and well-trained intake personnel, the IPSU will be able to manage its workload. TAS is available to consult with Accounts Management to develop and review appropriate procedures for the IPSU.

CONCLUSION

In conclusion, the National Taxpayer Advocate offers these preliminary recommendations:

1. The IRS should devote the necessary resources to analyzing its identity theft data and revising the business rules.
2. The IPSU should conduct a preliminary analysis of identity theft victim accounts on the front end to identify all issues associated with the identity theft.
3. The IRS should sufficiently staff the IPSU to accommodate the increasing volume of identity theft cases.
4. The IPSU should follow the staffing model that TAS has adopted, with intake advocates to accept initial calls, develop the facts, identify issues, gather supporting documentation, and conduct a global review of the taxpayer's account.

[18] TAS cases are categorized as either "economic burden" cases or "systemic burden" cases. In economic burden cases, a taxpayer is experiencing economic harm or is about to suffer economic harm; is facing an immediate threat of adverse action; will incur significant costs if relief is not granted (including fees for professional representation); or will suffer irreparable injury or long term adverse impact if relief is not granted. Systemic burden cases include situations where the taxpayer has experienced a delay of more than 30 days to resolve a tax account problem; the taxpayer has not received a response or resolution to his or her problem by the date promised; a system or procedure has either failed to operate as intended or failed to resolve the taxpayer's problem or dispute within the IRS; the manner in which the tax laws are being administered raises considerations of equity or has impaired or will impair the taxpayer's rights; or the National Taxpayer Advocate determines compelling public policy warrants assistance to an individual or group of taxpayers. *See* IRM 13.1.7.2 (July 23, 2007).

IRS COMMENTS

IRS Identity Protection and Victim Assistance

Assisting taxpayers in preventing identity theft and responding to the resulting tax implications continue to be leading priorities for the IRS. The IRS appreciates that the National Taxpayer Advocate recognizes the significant progress we have made. We continue to commit significant resources to address the challenges posed in protecting taxpayers' identities and identity information. An enterprise-level identity protection vision serves as the foundation for our comprehensive approach to protect taxpayer identity information and combat identity theft. This vision categorizes IRS efforts into three key areas: victim assistance, outreach, and prevention.

Victim Assistance

It is a strategic goal of the IRS to expedite and improve issue resolution, while reducing burden, for taxpayers affected by identity theft.

IRS Identity Theft Affidavit

In April 2009, the IRS implemented the use of its new Identity Theft Affidavit (IRS Affidavit). This short form allows taxpayers who believe or know themselves to be victims of identity theft to self-identify to the IRS for the purposes of having an identity theft indicator placed on their tax accounts. The IRS Affidavit reduces taxpayer burden by requesting only the information needed by the IRS to validate the taxpayer's identity and determine which indicator is appropriate for the taxpayer's account. It also streamlines and enhances victim services by providing information for full service and a single contact. Based on feedback from stakeholders, the IRS has recently updated the IRS Affidavit to make it more user-friendly and efficient for taxpayers and IRS employees.

Identity Protection Specialized Unit

The IRS has provided taxpayers with a central point of contact for the resolution of tax administration issues caused by identity theft. The IPSU serves as both a primary point of contact for taxpayers who self-identify as victims of identity theft, and a central point of contact for victims for whom resolution of identity theft-related issues requires coordination among multiple functions within the IRS.

As the primary point of contact for self-identified victims, IPSU assistors, where appropriate, place identity theft indicators on taxpayer accounts and provide the guidance that equips taxpayers with the resources to protect themselves from further, non-tax related affects of identity theft. The IPSU also conducts a thorough review of taxpayer accounts to identify all tax administration issues arising from identity theft. In November 2009, the IPSU implemented an Integrated Automated Technologies (IAT) tool that applies various automated business rules to enable more efficient and effective account review. By

identifying new technology solutions such as the IAT, the IPSU continues to improve its processes and streamline assistance for victims of identity theft.

Identity Theft Indicators

The IRS has implemented a number of new indicators to distinguish and track legitimate returns from fraudulent returns submitted by identity thieves, as well as to track data loss events and identity theft with no impact on tax administration. Our identity theft indicators enable all IRS functions to identify affected accounts quickly and to monitor them throughout the resolution process. These efforts will reduce taxpayer burden by expediting the process for identifying potential victims and successfully resolving their current tax issues. In addition, the indicators may help prevent future identity theft related tax issues.

In 2009, the IRS has placed identity theft indicators on the accounts of over 180,000 victims, representing a substantial increase over 2008. We are enhancing the number and type of indicators used to protect taxpayers from identity theft and have submitted programming for four new indicators to mark taxpayer accounts. This robust portfolio of indicators with the associated business rules and measures will increase the level of service to victims through better detection and resolution of identity theft cases.

Outreach

The IRS is committed to increasing awareness of identity protection through multiple communication channels and education efforts. This year, the IRS has again focused heavily on raising awareness of identity protection issues through direct contact with the tax practitioner and taxpayer communities.

We have updated our internal communication vehicles, including the IRM, to ensure employees know how and when to engage the IPSU for taxpayer assistance. We have also updated our publications for taxpayers and tax practitioners to include information about how to engage the IPSU for assistance. We also work with TAS to ensure our outreach efforts and communications include information on appropriate criteria for engaging TAS.

Nationwide Tax Forums

Led by our Office of Privacy, Information Protection, & Data Security (PIPDS), the IRS has addressed groups at over 40 events throughout the country, including six Nationwide Tax Forums. During the Nationwide Tax Forums, attended by over 14,000 practitioners, we engaged in numerous individual contacts and gave heavily attended presentations on identity theft, emphasizing the services provided by the IRS to victims.

Identity Protection Forum

In October 2009, the IRS hosted its second Identity Protection Forum, engaging key executives and experts in the fields of privacy and identity theft, in the domestic and international arenas, to share and acquire information on best practices for protecting and assisting

the public. The goal of the Forum was to share common experiences and successes in the protection of identity information and gain insights into trends and future developments in this area of growing interest.

Prevention

The IRS continues to develop a strong prevention program to reduce incidents of identity theft. This program is based upon three priorities: (1) reducing opportunities for thieves to obtain identity information; (2) reducing the opportunities for thieves to use data they have stolen; and (3) increasing deterrence efforts to discourage identity theft.

Online Fraud

The office of Online Fraud Detection and Prevention (OFDP) continues to work diligently to identify and combat online fraud against the IRS and taxpayers. OFDP collaborates with IRS Criminal Investigation, the Treasury Inspector General for Tax Administration (TIGTA), the Department of Justice, the Federal Bureau of Investigation, the FTC, and other law enforcement partners to pursue criminal investigations and prosecutions of phishing perpetrators. In successfully carrying out its mission, OFDP contributes to a reduction in the number of fraudulent refunds issued and helps to raise the public confidence in the e-filing process.

In calendar year 2009, OFDP has shut down over 4,280 phishing sites, of both domestic and international origin. This number represents a substantial increase over the number of sites taken down in 2008. OFDP also continues its robust outreach efforts and partnerships to ensure taxpayers are receiving the most current, useful information needed to protect them from online fraud.

Social Security Number Elimination and Reduction (SSN ER)

The IRS continues to work to reduce and eliminate the use of the SSN in our forms and business processes. This year, PIPDS worked with the IRS Chief Counsel to develop a pilot program permitting masking of Taxpayer Identification Numbers (TINs) on the payee statements of Forms 1099, 1098, and 5498. This effort will eliminate the presence of SSNs on thousands of information returns mailed to taxpayers during the 2010 and 2011 filing seasons. The IRS has also developed and implemented a new Research Command Code which enables our employees to research and access taxpayer account information without using the SSN.

Response to Recommendations

In her report, the National Taxpayer Advocate makes four preliminary recommendations for the IRS to "fine tune" its identity theft procedures. We are taking or have taken the following actions with respect to these recommendations:

Recommendation 1: The IRS should devote the necessary resources to analyzing its identity theft data and revising the business rules.

The IRS agrees to continuously analyze our identity theft data and revise the business rules for the identity protection filters accordingly. In January 2009, we began filtering any tax return filing activity on the accounts of taxpayers flagged in our system as victims of identity theft through business rules constructed following a thorough analysis of common indicators of fraud. The IRS continues to perfect these business rules based on an ongoing analysis of their efficacy. We have already implemented several programming changes to update the filters for the 2010 filing season and updated our case review processes to reduce case processing timeframes and expedite refunds.

Recommendation 2: The IPSU should conduct a preliminary analysis of identity theft victim accounts on the front end to identify all issues associated with the identity theft.

The IRS recognizes that a comprehensive preliminary account review facilitates efficient resolution of identity theft related taxpayer account issues. When a taxpayer contacts the IPSU, the IPSU Customer Service Representative (CSR) conducts a preliminary review of the taxpayer's account for any outstanding issues. Where identity theft issues are identified during this account analysis, the IPSU coordinates with other functions to expedite the resolution of all issues.

Direct contact with the primary function that owns the specific tax issue the taxpayer is experiencing still remains the most efficient means of resolution, as that function has the case background and expertise necessary. However, in April 2009, the IRS implemented global account review procedures in the IPSU for all cases where taxpayers have substantiated themselves as victims of identity theft with a tax administration impact. IPSU assistors thoroughly review these accounts to ensure that all identity theft related issues have been identified and resolved. Where there are outstanding problems, the IPSU coordinates with the other functions to expedite resolution before closing the case.

IPSU began the global review process with approximately 24,000 accounts marked in 2008 and completed review of these accounts by July 2009. Since then, the IPSU has reviewed an additional 15,000 accounts that were marked in 2009. As of November 2009, the IRS has resolved all identity theft related issues on the accounts of over 39,000 taxpayers through the global account review process.

Recommendation 3: The IRS should sufficiently staff the IPSU to accommodate the increasing volume of identity theft cases.

The IRS is committed to maintaining adequate staffing levels in the IPSU to account for the increasing volume of identity theft related contacts. To date, staffing levels in the IPSU have proven sufficient to handle the call volumes and paper inventory. We are closely monitoring the IPSU to ensure that we continue to provide adequate staffing to address the needs of taxpayers affected by identity theft.

As of November 2009, the IRS Wage and Investment Division has trained 339 CSRs to receive identity theft calls, both in English and Spanish. Additionally, IPSU has also trained 109 CSRs to work identity theft correspondence inventory in English and Spanish. Staffing required to handle current taxpayer demand is significantly less than the CSRs already trained for both phone and correspondence inventory.

We are closely monitoring IPSU staffing and will make adjustments, as needed, to maximize efficiency and ensure level of service is not compromised. Additionally, with the implementation of the new IAT tool, designed to streamline the global review process, workload efficiency is increasing. This increase is expected to continue as assistors become more familiar with the tool.

Recommendation 4: The IPSU should follow the staffing model that TAS has adopted, with intake advocates to accept initial calls, develop the facts, identify issues, gather supporting documentation, and conduct a global review of the taxpayer's account.

The IRS is always interested in exploring innovative ways to expedite resolution of taxpayer issues. TAS and W&I are currently developing a Memorandum of Understanding that will outline procedures under which IPSU assistors will follow a model similar to the TAS staffing model when working new identity theft cases that meet systemic burden criteria.

The IPSU currently uses a staffing model similar to TAS's for those cases that do not meet TAS criteria. The IPSU has an intake unit (phone assistors) that develops facts, identifies issues, and provides guidance to taxpayers on how to get their cases resolved in the most expeditious manner. The IPSU monitors these cases as they are worked by the function(s) responsible for addressing the specific technical issue(s). This process eliminates delays and systemic burden issues. Lastly, the IPSU conducts global reviews of all taxpayer's accounts with related identity theft issues to ensure a complete resolution of accounts.

As the IPSU continues to evolve, the IRS will continue to explore opportunities and, where appropriate, develop new procedures that improve work processes, promote efficiency, and reduce taxpayer burden.

Conclusion

The IRS has continued to make significant progress in the area of identity protection this year. We are committed to the ongoing implementation and improvement of our Identity Protection Vision. We will continue to engage taxpayers, the practitioner community, and industry experts in educational and collaborative outreach initiatives such as the Identity Protection Forum. We look forward to continuing to collaborate with the National Taxpayer Advocate in our efforts to identify, develop, and implement additional improvements in this important area of tax administration.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate recognizes that it is nearly impossible for the IRS to develop initial business rules that seamlessly filter out questionable returns while minimizing taxpayer burden. We are pleased that the IRS has a plan in place to continuously analyze its identity theft data and revise the business rules accordingly. In addition, we urge the IRS to remain flexible when dealing with taxpayers affected by the business rules.

The IRS states that an IPSU representative conducts a preliminary review of the taxpayer's account for any outstanding issues and coordinates with other functions to expedite the resolution of all issues. The National Taxpayer Advocate applauds this approach and will monitor its effectiveness. We are interested to see whether the other IRS functions are receptive to dealing with the additional issues uncovered during this account review, and how timely they take follow-up actions.

The National Taxpayer Advocate is pleased to learn that the current staffing level for the IPSU appears sufficient for the expected volume of calls and paper inventory. In our experience resolving identity theft cases, we have found these types of cases often involve multiple issues and span multiple tax periods. We are concerned that these complex cases will demand more time and attention than expected. We encourage the IRS to closely monitor the staffing level of the IPSU and adjust the number of assistors as the need arises.

The National Taxpayer Advocate appreciates the IRS's willingness to adopt a staffing model similar to the TAS model when working identity theft cases. With an intake unit that develops facts, identifies issues, and provides guidance to taxpayers on how to get their cases resolved in the most expeditious manner, we believe that the IPSU will provide the most efficient service to identity theft victims.

Recommendations

The National Taxpayer Advocate appreciates the responsiveness shown by the IRS to our concerns and has no further recommendations at this time. However, we will continue to monitor the progress of the IPSU as it assists victims of identity theft. We will also work to complete the Memorandum of Understanding between TAS and W&I regarding the transfer of TAS cases, while ensuring that taxpayers are not harmed by the transfer of such cases.

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

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).[1] The FPLP is an automated system that allows continuous levies to be issued for up to 15 percent of federal payments due to taxpayers who have unpaid federal tax liabilities.[2]

While FPLP levies can attach to a variety of federal sources of income, ranging from salaries to retirement income to federal contractor (or vendor) payments, the bulk of FPLP levy payments have historically been related to Social Security benefits. Although the IRS initially employed an income filter to systemically 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.[3] The IRS did so in response to a 2003 General Accounting Office (now the Government Accountability Office) study that concluded the filter was an "inaccurate indicator of a taxpayer's ability to pay."[4]

Although the IRS committed to work in partnership with TAS on a research project to determine whether effective income and hardship filters could be created and implemented, TAS and IRS initial efforts to develop a filter did not result in agreement. In 2008, TAS Research designed, developed, and preliminarily tested a filtering model to determine whether the FPLP levy on Social Security benefits will cause a taxpayer economic hardship.[5] The new TAS model used information from tax returns and payor documents to estimate a taxpayer's income, and used other tax return data to estimate expenses routinely allowed by the IRS, to determine the taxpayer's ability to pay. The model then compares these two amounts to determine whether the taxpayer could afford to pay the FPLP levy on Social Security benefits. Extensive testing found that overall, the TAS model demonstrated sufficient reliability to be considered for use by the IRS to protect low income taxpayers from being harmed by the FPLP.[6]

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1 *See* National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, 46-72 (*Building a Better Filter: Protecting Lower Income Social Security Recipients from the Federal Payment Levy Program*); National Taxpayer Advocate 2007 Annual Report to Congress 324-36; National Taxpayer Advocate 2006 Annual Report to Congress 110-29, 141-56; National Taxpayer Advocate 2005 Annual Report to Congress 123-35; National Taxpayer Advocate 2004 Annual Report to Congress 246-63; National Taxpayer Advocate 2003 Annual Report to Congress 206-12; National Taxpayer Advocate 2001 Annual Report to Congress 202-09. *See also* IRC § 6331(h)(2)(A).

2 IRC § 6331(h)(2)(A), as prescribed by the Taxpayer Relief Act of 1997 (Pub. L. 105-34) § 1024, authorizes the IRS to issue continuous levies on certain federal payments.

3 This filter was known as the Total Positive Income indicator and was implemented in January of 2002 at the request of the National Taxpayer Advocate.

4 General Accounting Office, GAO 03-356, *Tax Administration, Federal Payment Levy Program Measures Performance and Equity Can Be Improved* 11 (Mar. 6, 2003).

5 *See* National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, 46-72 (*Building a Better Filter: Protecting Lower Income Social Security Recipients from the Federal Payment Levy Program*).

6 The model found that in over one-third of all FPLP cases subject to an ongoing FPLP levy, taxpayers would likely be classified as unable to pay based on current IRS allowable expense guidelines. Further, more than one-quarter of FPLP taxpayers who paid their tax liability, entered into an installment agreement with the IRS or were subject to an ongoing FPLP levy had incomes at or below the poverty level. *Id.* at 49.

Subsequent to publication of the TAS study in the 2008 Annual Report to Congress, the National Taxpayer Advocate and the IRS Wage and Investment Division Director of Compliance met regularly to explore how to incorporate the TAS filtering model into existing IRS systems. We are pleased that the IRS has agreed to implement the low income filter (LIF) for taxpayers receiving Social Security and Railroad Retirement Board benefits. The LIF will exclude taxpayers from the FPLP if their estimated income (based on internal IRS data) is less than 250 percent of the poverty level guideline as defined by the Department of Health and Human Services.[7] (Taxpayers that are removed from the FPLP process due to the income filter may continue to be subject to the normal non-FPLP collection procedures). To allow the IRS enough time to make programming changes, this LIF has a target implementation date of January 2011. The National Taxpayer Advocate commends the IRS for its efforts to protect taxpayers and looks forward to working with the IRS to monitor the effectiveness of this LIF.

[7] To compute the taxpayer's income, where the taxpayer has filed a tax return for the most recent year or two, the IRS will use the greater of the total positive income (TPI) from that return, or income based on payor documents filed with IRS for that year. Where no such return was filed, the IRS will use payor documents for the most recent tax year. To determine family size, which is a component of the federal poverty level computation, the IRS will use the family unit size claimed on the taxpayer's most recent return filed for the last two years, or if no such return is filed, the IRS will assume a family unit size of one. The IRS has also committed to filtering out taxpayers for whom an Identity Theft indicator is present on the entity. IRS, *Federal Payment Levy Program: Proposed Process to Implement Low Income Filter for Social Security and Railroad Retirement* (Sept. 29, 2009).