

National Taxpayer Advocate

Annual Report to Congress

*2011 Annual Report to Congress*

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# NATIONAL TAXPAYER ADVOCATE

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2011  
ANNUAL REPORT  
TO CONGRESS

Executive Summary:  
Preface & Highlights



YOUR VOICE AT THE IRS

December 31, 2011



National Taxpayer Advocate

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**TAXPAYER**  
**ADVOCATE**  
**SERVICE**

**YOUR VOICE AT THE IRS**

*There may be a tendency  
to overcentralize operations,  
to overextend capabilities, and, yes,  
to capitulate to  
overmechanization and underhumanization  
of tax administration.*

*In brief IRS must constantly weigh  
machine capability  
against the  
actual and psychic costs  
to the nation.*

— Mortimer M. Caplin —

*Commissioner Caplin Reviews his Record as IRS Chief [1964]*

29 VA. Tax Rev. 177, 180 (2009)

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**Honorable Members of Congress:**

I respectfully submit for your consideration the National Taxpayer Advocate's 2011 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.

The scope of the Annual Report to Congress is by statute quite broad, and this year, the Report embraces the entire modern history of tax administration. The Report's expansive reach is necessary, to my thinking, because of the lack of understanding about taxation in public discourse today. We thought it would be a good idea to look at what the United States tax system encompassed when enacted in 1913, and how it has changed over the years, up to today – 2011.

Thus, the starting point for our review is actually in Volume 2 of this Report – a research study titled “From Tax Collector to Fiscal Automaton: Demographic History of Federal Income Tax Administration, 1913–2011.” This study analyzes the evolution of modern U.S. tax administration. What began as a system that focused primarily on revenue raising and affected only the most affluent and elite taxpayers grew massively during World War II to raise funds for the war effort, and drew the middle class into the taxpayer base. From the latter part of the 20<sup>th</sup> century through today, the system has grown further to encompass the low income population and have its mission expanded by Congress from being primarily the federal government's revenue collector to become a favored disburser of government payments and benefits as well.

The implications of this evolution cannot be overstated. The individual taxpayer population in 1913 was estimated at 358,000, grew to 47.1 million in 1944, and today stands at 141.2 million. Growth at this scale and pace forced the IRS to evolve from an agency mired in manual processing and political patronage to an organization driven by automated processes and organized around stove-piped operations delivered by career civil servants whose exercise of judgment and discretion is severely limited.

Moreover, the growth of the tax system has not been limited to absolute numbers. There is a parallel growth in the diversity of the population that the IRS serves.<sup>1</sup> The 2010 Census identifies about a quarter of the population as racial minorities, not counting Hispanics, over half of whom are identified as white.<sup>2</sup> About a fifth of the U.S. population speaks a language other than English at home,<sup>3</sup> and the tax law now applies to low income individuals, who make up 15.1 percent of the population.<sup>4</sup> Millions of individuals have experienced domestic violence and abuse in their lives, which, as we discuss in this Report, can have serious and negative impact on these individuals' tax

<sup>1</sup> See Introduction to Diversity Issues: *The IRS Should Do More to Accommodate Changing Taxpayer Demographics*, *infra* (introducing four Most Serious Problems discussing tax issues that relate specifically to the diversity of the U.S. taxpayer base).

<sup>2</sup> U.S. Bur. of the Census, *Overview of Race & Hispanic Origin*, 2010 Census Brief (Mar. 2011) Table 1 at 4, Table 2 at 6.

<sup>3</sup> Census, 2005–09 Amer. Comm. Survey, Table S0501, *Selected Characteristics of the Native and Foreign-born Populations* (relating to population five years and older).

<sup>4</sup> Census, *Income, Poverty and Health Insurance Coverage in the U.S.: 2010* (Sept. 13, 2011).

situations.<sup>5</sup> Meanwhile, globalization of commerce has caused millions of U.S. citizens and non-U.S. citizens abroad and in the U.S., along with hundreds of thousands of small businesses, to become engaged in international economic activity that draws them into the Kafka-esque U.S. international tax regime.<sup>6</sup>

The expansion of the taxpayer base in numbers and diversity has, not surprisingly, increased the amount and difficulty of the IRS's job. But there is more. Far more. The Internal Revenue Code has been growing longer and more complicated by the year – and sometimes by the day. In prior reports, I have identified tax code complexity as the most serious problem facing taxpayers and the IRS alike.<sup>7</sup> Last year we noted, for example, that a search of the tax code turned up 3.8 million words and that there had been approximately 4,428 changes to the code over the preceding ten years – an average of more than one a day, including an estimated 579 changes in 2010 alone.<sup>8</sup> For every one of these changes, the IRS must explain the new provision to taxpayers, write computer code so it can process returns affected by the provision, and train its auditors so that improper claims can be identified.

In recent years, too, organized and not-so-organized criminals have sought to profit off the tax system by submitting bogus refund claims and often by stealing and utilizing the identity of another taxpayer. Each year, the IRS's task in identifying these claims has become more challenging, with the inevitable result that some fraudulent claims are never identified and many legitimate claims are mistakenly held up, imposing significant burden on honest taxpayers.<sup>9</sup>

And despite a huge expansion in the IRS's workload, Congress has reduced the IRS's funding in each of the last two years. As a consequence of all these factors, taxpayer service levels have declined. The IRS is now unable to answer three out of every ten calls it receives from taxpayers seeking to speak with a telephone assistor, and as of the end of fiscal year 2011, nearly half of all taxpayer correspondence in the IRS's adjustments inventory was taking more than 6½ weeks to answer.

The IRS has been a very effective agency, but as we discuss in this report, the imbalance between its workload and its resources is becoming unmanageable. It is up to Congress to ensure that the IRS continues to be effective, either by reducing the IRS's workload or by providing adequate funding to enable it to accomplish its assigned mission.

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<sup>5</sup> See Most Serious Problem: *The IRS Does Not Sufficiently Recognize and Address Domestic Violence and Abuse and Its Effects on Tax Administration*, *infra*.

<sup>6</sup> See Introduction to International Issues: *Compliance Challenges Increase International Taxpayers' Need for IRS Services and May Undermine the Effectiveness of IRS Enforcement Initiatives in the International Arena*, *infra* (introducing six Most Serious Problems addressing tax problems of international taxpayers).

<sup>7</sup> See National Taxpayer Advocate 2010 Annual Report to Congress 3-14 (Most Serious Problem: *The Time for Tax Reform Is Now*); National Taxpayer Advocate 2008 Annual Report to Congress 3-14 (Most Serious Problem: *The Complexity of the Tax Code*); see also *Hearing on Fundamental Tax Reform: Hearing Before the H. Comm. on Ways and Means*, 112th Cong. (2011) (statement of Nina E. Olson, National Taxpayer Advocate).

<sup>8</sup> See National Taxpayer Advocate 2010 Annual Report to Congress 4.

<sup>9</sup> See Most Serious Problems: *Tax-Related Identity Theft Continues to Impose Significant Burdens on Taxpayers and the IRS* and *The IRS's Wage and Withholding Verification Procedures May Encroach on Taxpayer Rights and Delay Refund Processing*, *infra*.

In our #1 Most Serious Problem, *The IRS Is Not Adequately Funded to Serve Taxpayers and Collect Taxes*, we elaborate on our concern that the IRS cannot keep pace with its workload in a declining budget environment without seriously eroding the taxpayer service that taxpayers deserve. Moreover, under pressure to “do more with less,” we note that the IRS is in danger of implementing its enforcement and compliance initiatives in a manner that fails to provide taxpayers with adequate notice to enable them to understand what actions are being proposed and the basis for those actions – and an adequate opportunity to present their own information to show the IRS has made an error.<sup>10</sup>

We have been here before. In the years before the landmark Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98),<sup>11</sup> Congress significantly cut the IRS budget while increasing pressure on it to collect revenue. We know what happened during that time — IRS employees and taxpayers were at loggerheads, with each side distrustful of the other and the IRS taking enforcement actions to meet stated or unstated quotas and failing to listen to taxpayers, who viewed the IRS as an adversary.

RRA 98 established many safeguards to prevent this breakdown from occurring again. In light of the IRS’s indiscriminate use of automation to avoid personal contact with taxpayers and the sheer volume of work to be accomplished, however, the IRS is increasingly in danger of judging taxpayers as noncompliant when in fact they are not. Throughout this Report, we describe IRS practices and procedures that harm taxpayers by acting on assumptions of noncompliance arrived at by automated processes that do not solicit, encourage, or allow taxpayer response.<sup>12</sup> We identify instances where the IRS, through automation, is imposing undue burden on taxpayers that it could eliminate through better use of its internal data (ironically, through automated processes).<sup>13</sup>

It has been 13½ years since we have had major taxpayer rights legislation. Our laws have not kept pace with our notions of procedural fairness in 21<sup>st</sup> century tax administration, particularly given the tax system’s expanded and diverse taxpayer base and duties. We thus reiterate our call for Congress to pass a Taxpayer Bill of Rights, and we include in that recommendation many of the legislative proposals we have made in previous reports, some of which have been introduced in Congress, and all of which, we believe, will provide taxpayers with needed protections and instill greater confidence in the tax system.<sup>14</sup>

To treat taxpayers fairly and provide them with due process while collecting over 90 percent of the federal government’s revenue and delivering economic and social programs to targeted

<sup>10</sup> See, e.g., Most Serious Problem: *Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights*, *infra*.

<sup>11</sup> Pub. L. No. 105-206, 112 Stat. 685 (1998).

<sup>12</sup> See, e.g., Most Serious Problem: *The IRS Should Reevaluate Earned Income Tax Credit Compliance Measures and Take Steps to Improve Both Service and Compliance*; Most Serious Problem: *The IRS Does Not Emphasize the Importance of Personal Taxpayer Contact as an Effective Tax Collection Tool*; and *An Analysis of the IRS Examination Strategy: Proposals to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights* (vol. 2), *infra*.

<sup>13</sup> See, e.g., Most Serious Problem: *Automated “Enforcement Assessments” Gone Wild: IRS Efforts to Address the Non-Filer Population Have Produced Questionable Business Results for the IRS, While Creating Serious Burden for Many Taxpayers, and Math Errors Committed on Individual Tax Returns: A Review of Math Error Notices Issued for Claimed Dependents* (vol. 2), *infra*.

<sup>14</sup> See Legislative Recommendation: *Enact Previous Recommendations of the National Taxpayer Advocate to Protect Taxpayer Rights*, *infra*.

populations – that is indeed the challenge facing the IRS. But Congress bears the responsibility here to fund the “accounts receivable” function of the federal government. Policymakers may disagree fervently about the appropriate level of taxation, but whatever the level is, the law must be enforced fairly and consistently. The IRS must communicate and engage taxpayers as it finds them, with all their diversity of characteristics. To accomplish its dual mission of tax collection and benefits administration, the IRS must be adequately funded. Failure to fund the IRS sufficiently so that it can treat taxpayers properly (which includes both service and enforcement) breaches the social contract with U.S. taxpayers upon which our voluntary tax compliance system was founded – and limits the IRS’s ability to collect much-needed federal revenue.

As noted earlier, this Annual Report to Congress covers the full waterfront of tax administration – wealthy and low income taxpayers; international, domestic, and tax-exempt taxpayers; personal contact and automation; collection and examination; and the challenge to provide due process to taxpayers in an era of “real time” use of third-party information reporting, identity theft, and organized refund fraud. There is simply too much in this report to discuss in one introduction. So, the National Taxpayer Advocate herself is belatedly entering the 21<sup>st</sup> century by inaugurating a blog. In each blog posting, I plan to highlight one aspect of this Report and summarize our concerns, describe what the IRS is doing to address the issue, and provide updates. The Office of the Taxpayer Advocate and I personally are grateful for the consideration Congress gives our perspective each year, and through a periodic blog, we hope to make the Annual Report to Congress a living document by providing status updates on important issues throughout the year as well as for informing and engaging the taxpaying public about the role of taxation and the IRS in our national life. I hope to see you online at [www.TaxpayerAdvocate.irs.gov](http://www.TaxpayerAdvocate.irs.gov)!

Respectfully submitted,



Nina E. Olson  
National Taxpayer Advocate  
31 December 2011

## The Most Serious Problems Encountered by Taxpayers

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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 2011, the National Taxpayer Advocate has identified, analyzed, and offered recommendations to assist the IRS in resolving 22 such problems. Fifteen of these 22 problems — five revenue protection issues, six international issues, and four diversity issues — are further grouped under specific, focused introductions. This year's report also includes status updates on four issues previously raised by the National Taxpayer Advocate or addressed in previous Annual Reports.

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

The issues described in the report are as follows:

## The Most Serious Problems Encountered by Taxpayers

**1. The IRS Is Not Adequately Funded to Serve Taxpayers and Collect Taxes***Problem*

The most serious problem facing U.S. taxpayers is the combination of the IRS's expanding workload and the limited resources available to the IRS to handle it.

Among the consequences:

1. The IRS is unable to adequately meet the service needs of the taxpaying public.
2. The IRS is unable to adequately detect and address noncompliance, requiring honest taxpayers to shoulder a disproportionately large share of the tax burden.
3. The IRS is unable to maximize revenue collection, contributing to the federal budget deficit.

*Analysis*

The workload of the IRS has expanded substantially in recent years due to a variety of factors, including the increasing complexity of the tax code and its frequent changes, the service needs of an increasingly diverse taxpayer population, a surge in refund fraud and tax-related identity theft, and the need to implement new third-party information reporting requirements. However, the IRS has not received sufficient resources to manage its expanding workload; in fact, the IRS budget was reduced slightly from fiscal year (FY) 2010 to FY 2011, and it has been cut by an additional 2.5 percent in FY 2012.

These reductions are affecting the IRS's operations, particularly taxpayer service. Two key measures of taxpayer service are the IRS's ability to answer taxpayer telephone calls and its ability to respond to taxpayer correspondence. From FY 2004 to FY 2011, the percentage of calls the IRS answered from taxpayers seeking to speak with a telephone assistant dropped from 87 percent to 70 percent. Over the same period, the IRS's ability to process taxpayer correspondence in a timely manner also declined. The percentage of taxpayer correspondence in the tax adjustments inventory classified as "over-age" (generally, 45 days or older) increased from 11.5 percent at the end of FY 2004 to 47.0 percent at the end of FY 2011. Thus, the IRS is now unable to answer three out of every ten calls it receives, and nearly half of all taxpayers who write to the IRS must wait more than 6-1/2 weeks for a reply.

The IRS is the one agency of the federal government with which most Americans interact every year. To a significant extent, the public's perception of the fairness and effectiveness of their government is shaped by their experience in dealing with the IRS. Few people enjoy paying taxes, but most recognize it is a necessary requirement to provide for a civilized society. Yet the public expects — and has a right to expect — that the government will make the process of paying taxes as painless as possible. If taxpayers experience unnecessary hassles in trying to do their civic duty, their cynicism about the competence and

## The Most Serious Problems Encountered by Taxpayers

fairness of the government will increase. To maximize public confidence, the tax collector should be staffed at a level that enables it to meet the needs of all taxpayers.

With more resources, the IRS could also do more to improve tax compliance. This is important both to fund the operations of government and to ensure that compliant taxpayers are not ultimately required to pay more to subsidize noncompliance by others. Dividing the most recent tax gap estimate of \$290 billion by the number of households in the United States suggests that the average household is being assessed an annual “surtax” of about \$2,680 to enable the federal government to raise the same level of revenue it would collect if all taxpayers were to report their income and pay their taxes in full. That is not a burden we should expect our nation’s taxpayers to bear lightly.

The IRS is effectively the Accounts Receivable Department of the federal government. It collects more than 90 percent of all federal revenue and therefore provides the funds that make all other federal spending possible. On a budget of about \$12.1 billion, the IRS collected about \$2.42 trillion in FY 2011. In other words, for every \$1 that Congress appropriated for the IRS, the IRS collected about \$200 in return.

If the federal government were a private company, its management would fund the Accounts Receivable Department at a level that it believed would maximize the company’s bottom line. Since the IRS is not a private company, maximizing the bottom line is not – in and of itself – the only goal. But the public sector analogue should be to maximize tax compliance, especially voluntary compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden. Studies show that if given more resources, the IRS could better meet taxpayer needs **and** collect substantially more revenue.

### *Recommendation*

In light of the IRS’s unique role as the federal government’s accounts receivable department, the National Taxpayer Advocate recommends that Congress develop new budget procedures to ensure that the IRS is funded at whatever level will maximize tax compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden. In the short run, this approach should include carving out the IRS from discretionary budget freezes intended to reduce the budget deficit, as cuts to the IRS budget are likely to increase the deficit. Over the longer term, this approach may include exempting the IRS from spending ceilings or even taking the IRS off-budget.

## The Most Serious Problems Encountered by Taxpayers

**Introduction to Revenue Protection Issues: As the IRS Relies More Heavily on Automation to Strengthen Enforcement, There Is Increased Risk It Will Assume Taxpayers Are Cheating, Confuse Taxpayers About Their Rights, and Sidestep Longstanding Taxpayer Protections***Problem*

The IRS increasingly relies on automated data matching procedures to adjust tax liabilities and “protect” revenue. Mismatches may remain unexplained for a wide variety of reasons, even if the taxpayer’s return is correct. Moreover, by defining these procedures as “not an examination,” without explaining what they are and what taxpayer rights apply, the IRS abridges longstanding taxpayer rights. In other words, the IRS is able to pick and choose which taxpayer rights it is willing to provide.

*Analysis*

Historically, when a taxpayer filed a return, the IRS assumed it was correct. The IRS generally did not disturb the taxpayer’s self-assessment unless it examined the return and identified a problem. Accordingly, Congress mandated examination procedures designed to minimize burden, inform taxpayers of their rights, and ensure the IRS determination was correct.

Today, when a taxpayer’s return is inconsistent with data from third parties, the IRS often assumes the return is wrong and the third-party data are correct — without conducting an actual examination. In fiscal year (FY) 2010, the IRS made about 15 million contacts that taxpayers might regard as examinations, but treated only about ten percent (1.6 million) as “real” examinations — and it conducted about 78 percent of these by correspondence in a highly-automated campus setting. Low income taxpayers are often subject to these automated adjustments. The National Taxpayer Advocate is concerned that new streamlined procedures bypass key taxpayer rights that the IRS routinely provides to high-income taxpayers who are subject to “real” examinations.

It is easy to understand why the IRS has embraced automation, which often makes sense. However, automated adjustments may be less accurate than face-to-face examinations, particularly when the third-party data are unreliable or either the IRS or the taxpayer has difficulty communicating. Thus, as the IRS increases automation to “protect revenue,” its approach will only be balanced if it also increases efforts to protect taxpayers who are trying to comply as well as longstanding taxpayer rights.

*Recommendations*

The National Taxpayer Advocate recommends that the IRS ensure its automated systems use only the most reliable data; its letters reach taxpayers and clearly explain the discrepancy along with any applicable procedures and taxpayer rights; and its mitigation procedures make it easy for taxpayers to communicate with the IRS to explain apparent discrepancies and resolve problems. More specific recommendations appear in the most serious problems that follow.

## 2. The IRS's Wage and Withholding Verification Procedures May Encroach on Taxpayer Rights and Delay Refund Processing

### *Problem*

The IRS is responsible for processing over 141 million individual income tax returns annually, including nearly 120 million requests for refunds. It must guard against illegitimate refund requests while expeditiously processing legitimate returns and paying out legitimate refund claims. The dual tasks of fraud prevention and timely processing present challenges even in simple tax systems, and ours is far from simple. The recent increase in spending programs run through the tax code, combined with a reduction in IRS funding, has made the IRS's job much harder. To cope with a surge of new refund schemes, the IRS has expanded its use of various automated screens to filter out questionable refund claims. The result is that more legitimate taxpayers are becoming ensnared in the IRS's revenue protection apparatus.

### *Analysis*

The Accounts Management Taxpayer Assurance Program (AMTAP) delayed nearly two million refund claims in fiscal year (FY) 2011, identifying them as questionable or potentially fraudulent. The Electronic Fraud Detection System (EFDS) selected over one million returns for screening, while an additional 893,000 returns were identified as part of the Operation Mass Mail (OMM) scheme in calendar year 2011. The IRS does not notify taxpayers caught up in the OMM filters, even though the taxpayers are innocent approximately eight percent of the time. While the number of returns screened by EFDS rose by 72 percent, AMTAP staffing grew by less than nine percent, causing AMTAP inventory to soar. In FY 2011, TAS received over 21,000 pre-refund cases, a 504 percent increase over FY 2010. In a TAS study of a representative sample of pre-refund cases, the average delay in processing was over 25 weeks. Notably, taxpayers in this study who came to TAS with pre-refund problems ultimately received relief 75 percent of the time. Inadequate taxpayer communication, mounting inventory, and insufficient staffing are creating problems reminiscent of the time when the IRS's Criminal Investigation (CI) division verified suspect refund claims through its Questionable Refund Program. The IRS moved refund verification from CI to the Wage and Investment division in 2009, yet many of our concerns remain.

### *Recommendations*

The National Taxpayer Advocate recommends that the IRS give AMTAP enough employees to work inventory timely; make third-party data available sooner in the filing season to assist in wage verification; systemically release refunds after 70 days if the IRS cannot determine that the return is part of a known scheme or requires greater scrutiny; when considering any front-end verification procedures, also develop procedures to promptly help taxpayers who show they have filed legitimate refund claims; when considering alternative treatments of certain returns, determine the specific legal basis for the proposed action (or non-action); before "auto-voiding" (*i.e.*, declining to process) any returns; give the

The Most Serious Problems Encountered by Taxpayers

taxpayers a chance to correct or explain the questionable items; and when denying refund claims using an automated process, include language in the notice alerting taxpayers that the tax return is being examined or that they are under audit to make clearer that there are significant legal consequences for failing to respond to the notice by the deadline.

### 3. Tax-Related Identity Theft Continues to Impose Significant Burdens on Taxpayers and the IRS

#### *Problem*

Tax-related identity theft is a rapidly growing crime that often imposes enormous financial, emotional, and time-consuming burdens on its victims. TAS has worked closely with the IRS to improve servicewide efforts to assist identity theft victims. Although the IRS has adopted many of our recommendations and made significant progress in this area, the IRS's approach to identity theft is still not working as intended. In fiscal year (FY) 2011, the centralized Identity Protection Specialized Unit (IPSU) received more than 226,000 cases, a 20 percent increase from FY 2010. Despite the establishment of the IPSU, TAS still experienced a 97-percent increase in stolen identity cases in FY 2011, on top of a 23-percent increase in FY 2010.

#### *Analysis*

In June 2011, the IRS convened a task force to review and find ways to improve the current strategy and procedures for helping identity theft victims. The task force identified more than 50 procedural gaps and made numerous recommendations, including the issuance of an Identity Protection PIN to certain victims. One major recommendation was for the IRS to create a specialized unit *within each unit or organization* to work identity theft cases. Under this model, each function would retain responsibility for individual aspects of the case, but would rely on employees who receive specialized training to assist the victims. TAS supports the specialized approach, but notes the IRS still needs a "traffic cop" to see that the right unit handles each case in an acceptable time. The National Taxpayer Advocate believes the IPSU should continue to serve as the single point of contact for taxpayers and develop agreements with other IRS units to govern the process and acceptable times for response.

#### *Recommendations*

The National Taxpayer Advocate recommends that the IRS negotiate service level agreements between the Identity Protection Specialized Unit and the various other IRS functions that handle identity theft issues; establish measures for timeliness of actions on identity theft cases; develop an effective mitigation strategy to help taxpayers caught in the IRS's identity theft "filters" to obtain legitimate refunds timely; allow taxpayers to turn off their ability to file returns electronically; in conjunction with the Social Security Administration, seek a modification of the consent judgment that requires the SSA to release taxpayers' unredacted Social Security numbers; and establish a point of contact in the Wage and Investment (W&I) division so that Criminal Investigation or other IRS operations can supply lists of victims from their investigations of identity theft schemes and W&I can promptly mark the accounts accordingly.

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**4. Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights***Problem*

The IRS is authorized, in specific instances, to use its math error authority to summarily assess tax without first providing the taxpayer with access to the pre-payment forum of the U.S. Tax Court. Both the Treasury Inspector General for Tax Administration and the Government Accountability Office have recently urged the IRS to increase its use of this authority, describing it as a cost-effective way to process new items on tax returns, such as the First-Time Homebuyer Credit (FTHBC). This call for expanded authority is designed to prevent the IRS from paying refunds to taxpayers who improperly claim credits like the FTHBC. However, when considering math error expansion, the IRS should consider the following issues and how they erode taxpayer protections, threaten a taxpayer's access to Tax Court, and the potential loss of significant tax benefits:

- Math error notices are still not clearly written, making it hard for taxpayers to determine what has changed on their returns and whether to accept or contest the adjustments.
- The IRS does not process taxpayer responses to math error notices timely, which may delay refunds, and often does not work these responses accurately.
- The IRS can resolve some math error discrepancies through internal research, relieving some of the burden on taxpayers.
- Math error authority includes adjustments to returns “post-processing,” which can lead to unexpected assessments long after the returns were filed.

*Analysis*

Recent expansion of math error authority has contributed to IRS problems in using the authority efficiently and effectively. The IRS does not always work taxpayer responses to math error notices accurately, perhaps because the IRS is using math error authority in situations where a facts-and-circumstances analysis is more appropriate. For example, when the IRS used math error authority in 2010 to disallow exemptions for dependent children on approximately 300,000 returns, it had to reverse about 50 percent of the adjustments. The IRS could prevent some of these problems by resolving math error discrepancies through internal research. A TAS study found the IRS could reconcile missing or incorrect Taxpayer Identification Numbers on a return with existing information 56 percent of the time. Taxpayers are often confused by math error procedures such as adjustments made “post-processing.” This means taxpayers who thought the IRS had accepted their returns as filed may be notified months or even years later that the IRS has assessed additional tax due to a math error.

## The Most Serious Problems Encountered by Taxpayers

*Recommendations*

The National Taxpayer Advocate recommends that the IRS direct employees to conduct internal research to resolve clerical errors, such as incorrect entries of dependents' tax identification numbers or surnames; examine math error abatement rates after each filing season to identify high abatement areas and adjust procedures accordingly; revise math error notices to identify precisely the reason for a tax return change and which entries are inconsistent; and conduct a study with the National Taxpayer Advocate before implementing any new math error authority to evaluate whether the application of the new authority is accurate, negatively impacts taxpayers, or has a high abatement rate, and whether the IRS can resolve the cases with existing data.

## The Most Serious Problems Encountered by Taxpayers

**5. Automated “Enforcement Assessments” Gone Wild: IRS Efforts to Address the Non-File Population Have Produced Questionable Business Results for the IRS, While Creating Serious Burden for Many Taxpayers*****Problem***

The IRS’s wholesale use of automated “enforcement assessments,” *i.e.*, the Automated Substitute for Return (ASFR) program, has increased dramatically over the past decade, placing considerable drain on IRS Collection resources, with questionable benefits for revenue collection and compliance. Yet, IRS data indicate that most of these assessments are abated or reported as uncollectible.

- By fiscal year (FY) 2011, the number of returns generated by the ASFR increased by 896 percent of the number assessed in FY 2002.
- As of March 2011, ASFR assessments accounted for 43 percent of the IRS’s potentially collectible accounts receivable.
- In FY 2011, the IRS abated approximately 2.4 times as many ASFR TDA dollars as it collected (including refund offsets), and reported as CNC approximately four times the amount collected.
- From FY 2006 through FY 2011, IRS data indicate that less than ten percent of the TDA dollars established through the ASFR process has been collected.

The high volume of ASFR assessments clogs the collection process with unproductive work and artificially inflates the volume of IRS accounts receivable. It also wastes resources that the IRS could otherwise invest in cases that may be more collectible and tax assessments that are significantly more valid.

***Analysis***

IRS automated “enforcement assessments” are key tools for enforcing filing compliance, and their use has increased dramatically in recent years. However, the current ASFR process sacrifices taxpayer service for case-processing efficiencies. For example, even though the vast majority of ASFR cases are closed as “unagreed” or “no response,” the IRS makes little effort to ensure notices are sent to confirmed addresses, or make pre-assessment personal contacts with the affected taxpayers. While it appears that the IRS’s use of ASFR assessments may generate considerable potential accounts receivable, by design these assessments generally represent balances due that are inflated and inaccurate. We find little evidence that this approach is effective in actually collecting the delinquent revenue or in promoting the future compliance of the affected taxpayers.

***Recommendations***

To improve service, reduce burden, and increase the overall effectiveness of the ASFR program, the National Taxpayer Advocate recommends that the IRS place much greater

## The Most Serious Problems Encountered by Taxpayers

emphasis on IRS-initiated personal contacts and address verification before making assessments; expedite the implementation of the revised ASFR “90-day” letter; develop and implement a more realistic ASFR case-selection process; and improve the timeliness and quality of ASFR audit reconsiderations.

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**6. Changes to IRS Lien Filing Practices Are Needed to Improve Future Compliance, Increase Revenue Collection, and Minimize Economic Harm Inflicted on Financially Struggling Taxpayers*****Problem***

The National Taxpayer Advocate has repeatedly expressed concern about the adverse impact of IRS lien filing policies on taxpayers and future compliance. She has proposed several administrative and legislative steps to improve these policies and procedures, and to grant relief to taxpayers harmed by automatic filings. In response, the IRS announced a new effort to help financially struggling taxpayers get a “fresh start,” which included several positive changes in how it files and withdraws Notices of Federal Tax Lien (NFTLs). Despite these changes, the IRS filed 1,042,230 NFTLs in fiscal year (FY) 2011 against 713,524 taxpayers. Although the number of liens filed decreased by approximately 54,000 or five percent from FY 2010 levels, the IRS continued to file most NFTLs based on a dollar threshold of liability, without human review of the need for the lien based on the facts and circumstances of the case. As a result, the revised lien policies may not deliver the promised “fresh start” for many taxpayers who will grapple with the burden of NFTLs for years.

***Analysis***

A recent IRS focus group report ranked the NFTL filing as the number one factor that affects a taxpayer’s economic circumstances and credit report, ranking even higher than foreclosure and bankruptcy. The preliminary findings from a new, comprehensive TAS research study empirically support these observations and show that lien filings under the criteria for the study period negatively affect the compliance behavior and financial viability of taxpayers. Those in the study with liens filed against them were generally over six percent less likely than comparable taxpayers without liens to be compliant in paying current liabilities within the first three years after the lien filing. These taxpayers were still more than four and half percent less likely to reduce their initial liabilities than comparable non-lien taxpayers at least four to seven years after the lien was filed. In addition, taxpayers with liens were about 7.9 percent less likely to have an increase in their total positive income within the first three years after the lien filing, gradually declining to about 5.2 percent by the end of the full study period. The taxpayers with liens against them were also less likely to file required returns, with the increased likelihood of non-filing ranging from about one to three percent during the full study period. Some filings may make no business sense at all, generating significant downstream costs for the government without attaching to any tangible assets.

***Recommendations***

The National Taxpayer Advocate recommends the IRS collaborate with the National Taxpayer Advocate and TAS Research on the next phase of the TAS lien study to explore when lien filing might be most effective, and the impact of certain independent variables on taxpayer compliance, with or without a lien; develop new, meaningful lien filing determination criteria based on the results of the TAS study and in collaboration with the

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National Taxpayer Advocate; stop filing liens on taxpayers in currently not collectible (hardship) status based on the dollar threshold of unpaid liability, and instead make a lien filing determination at the time of the CNC determination; replace the mandatory NFTL filing on CNC taxpayers and those with no assets with a system of subsequent filing determinations based on periodic monitoring of whether the taxpayers have acquired assets or their financial situations have improved; and require managerial approval for NFTL filings in cases where the IRS never tried to make personal contact with the taxpayers, or notices sent to the taxpayers were returned as undeliverable.

## The Most Serious Problems Encountered by Taxpayers

**Introduction to International Issues: Compliance Challenges Increase International Taxpayers' Need for IRS Services and May Undermine the Effectiveness of IRS Enforcement Initiatives in the International Arena***Problem*

Millions of international taxpayers — including U.S. individuals working, living, or doing business abroad, U.S. entities doing business abroad, foreign individuals working or doing business in the U.S., and foreign entities doing business in the U.S. — face serious challenges in understanding and meeting their federal tax obligations. These challenges include the overwhelming complexity of international tax law; the complexity, level of detail, and sometimes the duplication present in international reporting requirements; penalties that may be disproportionately steep; the IRS's focus on stepped-up enforcement without adequate coordination and a corresponding increase in service; and most importantly, the lack of targeted taxpayer service for each group of international taxpayers.

*Analysis*

Globalization has driven millions of individual taxpayers and hundreds of thousands of small and medium-sized businesses to seek economic opportunities abroad. It also has increased competition among tax administration agencies for tax bases and sources of revenue. For this reason, 40 economies made it easier to pay taxes last year. However, a recent World Bank report ranks the United States 66<sup>th</sup> in the areas of time spent to comply with tax obligations and 62<sup>nd</sup> in the ease of paying taxes among 183 countries surveyed. The complexity of international tax law, combined with the procedural burden on international taxpayers, creates an environment where honest taxpayers who are trying their best to comply simply cannot. For some, this means paying more U.S. tax than is legally required, while others may be subject to steep civil and criminal penalties. Some U.S. taxpayers abroad find the tax requirements so confusing and the burden of complying with them so great that they give up their U.S. citizenship. A recent IRS study of taxpayer needs and preferences showed that international taxpayers may have a greater current need for IRS services than the general taxpayer population. Yet while the IRS has invested hundreds of millions of dollars in international enforcement programs, it has not adequately improved taxpayer services that would foster compliance.

*Most Serious Problems*

The following Most Serious Problem discussions relate to compliance challenges of international taxpayers:

- Foreign taxpayers face challenges in fulfilling U.S. tax obligations.
- Individual U.S. taxpayers working, living, or doing business abroad require expanded service targeting their specific needs and preferences.
- Small businesses involved in international economic activity need IRS assistance.
- Globalization requires greater internal IRS coordination of international taxpayer service.

## The Most Serious Problems Encountered by Taxpayers

- U.S. taxpayers abroad face challenges in understanding how the IRS will apply penalties to taxpayers who are reasonably trying to comply or return into compliance.
- The IRS's offshore voluntary disclosure program "Bait and Switch" may undermine trust in the IRS and future compliance programs.

## The Most Serious Problems Encountered by Taxpayers

**7. Foreign Taxpayers Face Challenges in Fulfilling U.S. Tax Obligations*****Problem***

Millions of foreigners enter the United States for personal and business reasons each year. Some of them may be subject to U.S. tax on U.S.-source income and have a U.S. filing obligation. Many are not proficient in English and are unfamiliar with U.S. tax concepts, which make them less equipped to deal with the complexity of the U.S. tax code and reporting requirements. These taxpayers face serious challenges in understanding and meeting their federal tax obligations.

***Analysis***

Taxpayers with U.S. filing obligations may reside in 194 countries and more than 60 territories, colonies, and dependencies of these countries. From fiscal year (FY) 2005 to FY 2010, the U.S. Department of State issued between 5.3 and 6.6 million nonimmigrant visas annually. While the IRS has no reliable estimate of the number of nonresident alien taxpayers and foreign business entities that may have U.S. tax filing obligations, it receives hundreds of thousands of returns from these taxpayers each year. The IRS attempts to reach out to this taxpayer population through Nationwide Tax Forums and webcasts, but it conducts most, if not all, in the United States. The target population by definition, however, resides outside the United States. Because limited in-person taxpayer assistance is available at only four tax attaché posts abroad, the IRS cannot adequately educate foreign taxpayers and their foreign-based tax advisors. In addition, because most IRS publications and website materials are not available in foreign languages, even web-based outreach to these taxpayers is problematic. Most foreign taxpayers who have U.S. filing obligations cannot apply for individual taxpayer identification numbers (ITIN), file their returns, or pay tax liabilities electronically.

***Recommendations***

The National Taxpayer Advocate recommends the IRS make relevant web resources, forms, and publications available in major foreign languages; develop focused outreach and separate publications in foreign languages for special groups of nonresident alien taxpayers and foreign entities; partner with the Department of State for virtual service delivery at U.S. embassies and consulates abroad; extend over the phone interpreter service to all IRS phone assistants; and allow electronic filing of 1040 NR series tax returns and ITIN applications for nonresident alien taxpayers.

## 8. Individual U.S. Taxpayers Working, Living, or Doing Business Abroad Require Expanded Service Targeting Their Specific Needs and Preferences

### *Problem*

The complexity of international tax law, combined with the procedural burden placed on five to seven million individual U.S. taxpayers working, living, and doing business abroad, creates an environment where taxpayers who are trying their best to comply simply cannot. For some taxpayers, this means paying more U.S. tax than is legally required, while others may be subject to steep civil and criminal penalties. These taxpayers need expanded service targeting their specific needs and preferences. While the IRS has substantially stepped up and invested hundreds of millions of dollars in international enforcement programs, it has not adequately improved taxpayer service programs that would foster compliance.

### *Analysis*

Many U.S. taxpayers abroad are confused by the complex legal and reporting requirements they face and are overwhelmed by the prospect of having to comply with them. Some are even renouncing their U.S. citizenship for that reason; about 4,000 people did so in fiscal years (FYs) 2005 to 2010. Renunciations increased more than tenfold from 146 in FY 2008 to 1,534 in FY 2010, with 1,024 renunciations in the first two quarters of FY 2011 alone. IRS Publication 4732, *Federal Tax Information for U.S. Taxpayers Living Abroad*, illustrates the complexity of the filing requirements. It refers to at least eight other relevant IRS publications, totaling 563 pages, and the additional documents referred to by these other publications include 4,727 pages of instructions, 667 pages of forms, and another 1,928 pages of form instructions, or 7,322 total pages. Finally, a recent IRS study of taxpayer needs and preferences showed that international taxpayers may have a “greater current need for IRS services than the general taxpayer population,” and another IRS study identified nine international locations that warranted serious consideration for expansion of tax attaché offices.

### *Recommendations*

The National Taxpayer Advocate recommends the IRS simplify tax return and information reporting forms for individual U.S. taxpayers living abroad; expand self-serve options, including TeleFile, fax, and Free File, and develop a free website application from [www.irs.gov](http://www.irs.gov) (NetFile); pilot secure email communications, virtual service delivery (VSD), and access to the MyIRS account application; and partner with the Department of State to train embassy and consulate staff to provide a full range of taxpayer services.

## The Most Serious Problems Encountered by Taxpayers

**9. Small Businesses Involved in International Economic Activity Need Targeted IRS Assistance***Problem*

As a result of globalization, an increasing number of taxpayers, including hundreds of thousands of small businesses, engage in international transactions. Forty-three IRS publications totaling 1,212 pages relate to U.S. small businesses involved in economic activity abroad. These publications in turn refer to other publications comprising 13,346 pages, 1,500 pages of forms, and another 5,018 pages of form instructions. This vastly complicates the search for the information that small business taxpayers need to meet their tax obligations. Because these taxpayers may have trouble understanding international tax rules and may not be able to afford professional representation, they need targeted taxpayer service.

*Analysis*

An estimated 253,000 small businesses made up 91.7 percent of all known exporters in calendar year 2009. From 2003 to 2010, U.S. small businesses' export activity increased about 80 percent to account for nearly \$500 billion in annual sales and about 30 percent of America's export revenues. The President's National Export Initiative requires all federal agencies to facilitate exports by small businesses and first-time exporters, and to help these businesses overcome administrative hurdles. However, the IRS does little to accommodate these taxpayers in terms of industry and country-specific education and outreach, special filing and tax law assistance, and affordable or low-cost pre-filing and post-filing programs, which are available to large and midsize businesses.

*Recommendations*

The National Taxpayer Advocate recommends the IRS survey the needs and preferences of U.S. small businesses involved in international transactions; develop outreach materials for small businesses involved in international transactions and country-specific materials for major trading partners; develop a special assistance program for these taxpayers, including a dedicated toll-free telephone line, a small business exporting center on the IRS website, and walk-in sites and workshops for small businesses involved in international activity; simplify information reporting for U.S. small businesses involved in international transactions; reduce filing fees for the Advanced Pricing Agreement program and letter rulings on international issues for small businesses; and test pilots of the Pre-Filing Agreement program, and other programs that are available for large businesses, for small businesses but with reduced fees.

## 10. Globalization Requires Greater Internal IRS Coordination of International Taxpayer Service

### *Problem*

In recent years, the IRS has devoted substantial resources to improving international tax administration and responding to the challenges of globalization. However, this strategy has focused on stepped-up enforcement without adequate IRS-wide coordination or a corresponding increase in service to international taxpayers. The lack of coordination may undermine international enforcement initiatives and discourage future compliance by taxpayers dealing with the complexity and procedural burden of the international tax rules.

### *Analysis*

Despite consolidation of all international compliance functions in the new Large Business and International Division, the IRS lacks an articulate international taxpayer service strategy. Recently, the IRS dissolved the International Planning and Operations Council (IPOC), the only servicewide forum for addressing international taxpayer service issues. The IRS is a member of the Forum on Tax Administration (FTA) and its Taxpayer Services Subgroup, which is devoted to sharing innovative approaches to taxpayer service among member countries. However, the IRS has no way to share this FTA information internally with the various operating divisions and functions, including TAS. In the absence of adequate service, an increased number of taxpayers seek help from TAS, the only IRS unit exclusively devoted to taxpayer service and resolving problems. International taxpayers' right to this assistance is constrained by the lack of Local Taxpayer Advocate (LTA) offices abroad.

### *Recommendations*

The National Taxpayer Advocate recommends the IRS reinstate the IPOC; create an international taxpayer service subgroup within IPOC to address specific needs and compliance challenges of international taxpayers and coordinate international taxpayer service initiatives for all IRS functions; and provide funding for TAS to establish LTA positions in each of the four existing tax attaché offices abroad and include such positions in future expansion of attaché offices.

## The Most Serious Problems Encountered by Taxpayers

**11. U.S. Taxpayers Abroad Face Challenges in Understanding How the IRS Will Apply Penalties to Taxpayers Who Are Reasonably Trying to Comply or Return into Compliance***Problem*

Although the IRS's longstanding policy is to use penalties "to encourage voluntary compliance," it may have used penalties as leverage against taxpayers who have entered into voluntary disclosure programs, often penalizing those who are trying to become compliant. Many appear to believe the IRS will always seek to apply the maximum penalties, regardless of the situation, even to "benign actors." Absent clear procedures and transparent guidance about how these benign actors can return into compliance without being subject to maximum penalties, the IRS is squandering an opportunity to substantially improve voluntary compliance by millions of low profile U.S. taxpayers abroad.

*Analysis*

U.S. taxpayers abroad who do not comply with complex information reporting requirements are subject to financially devastating penalties that often are not commensurate with the tax liability at issue. These penalties range from \$10,000 per violation to the greater of \$600,000 or 300 percent of the foreign account balance for willful failures continuing over a six-year period. Organizations representing U.S. taxpayers abroad and individual submitters have complained about Foreign Bank Account Report (FBAR) "penalty abuse" and application of excessive penalties to relatively benign actors. TAS and the U.S. Ambassador to Canada have received similar complaints from Canadians with dual U.S. citizenship who are confused and concerned about FBAR penalties. While the IRS recently issued an informal fact sheet providing some helpful guidance, this and other communications have not been vetted with the National Taxpayer Advocate or put out for public comment – and taxpayers generally cannot rely on fact sheets and press releases.

*Recommendations*

The National Taxpayer Advocate recommends the IRS issue guidance in the form of IRM changes or public guidance published in the Internal Revenue Bulletin that describes and reaffirms the taxpayer-favorable procedures regarding the application of the FBAR penalty; give taxpayers clear guidance about what to do if they discover they have inadvertently failed to file FBARs; reassure them that they are most likely to receive only a warning letter if they follow the instructions in the notice; include representatives of the Taxpayer Advocate Service on "servicewide" teams that are addressing and developing guidance about international information reporting requirements, penalties, and related compliance initiatives; and regularly consult with and provide briefings to the National Taxpayer Advocate on these issues.

## 12. The IRS's Offshore Voluntary Disclosure Program "Bait And Switch" May Undermine Trust for the IRS and Future Compliance Programs

### *Problem*

While the maximum penalty for a "willful" failure to report foreign accounts on Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts (FBAR)* is severe, people who voluntarily correct inadvertent violations are generally not subject to a significant penalty. Nonetheless, the IRS "strongly encouraged" nearly everyone with a violation to participate in the 2009 Offshore Voluntary Disclosure Program (OVDP) or face potentially excessive civil and criminal penalties. More than a year after the 2009 OVDP ended, the IRS changed key terms of the program to the detriment of those with inadvertent violations, damaging the IRS's credibility. The IRS's statements also leave the public confused and concerned that excessive FBAR penalties may apply to inadvertent violations.

### *Analysis*

The OVDP generally provided for a 20 percent "offshore" penalty in lieu of various penalties, including FBAR. However, the IRS announced that "[U]nder no circumstances will a taxpayer be required to pay a penalty greater than what he would otherwise be liable for under existing statutes." On March 1, 2011, more than a year after the 2009 OVDP ended, the IRS issued a memo suggesting it would no longer consider whether a taxpayer would pay less under existing statutes. Those with inadvertent violations could either agree to pay more than they should or "opt out" of the 2009 OVDP. Given the confusion surrounding what penalty would apply outside of the program, many agreed to the 20 percent penalty. Continuing concern that the IRS may apply excessive penalties for inadvertent violations has generated public outrage among those with foreign accounts, such as U.S. citizens living in Canada.

### *Recommendations*

The National Taxpayer Advocate recommends the IRS issue public guidance committing not to seek excessive penalties for inadvertent violations, revoke the March 1 memo, and clarify that participants in the 2009 OVDP will not be required to pay more than they would be liable for outside of the program. For consistency, she also recommends that the IRS offer to amend signed agreements from those who would pay less outside of the program.

## The Most Serious Problems Encountered by Taxpayers

**Introduction to Diversity Issues: The IRS Should Do More to Accommodate Changing Taxpayer Demographics***Problem*

Tax law refers to a generic taxpayer. Yet the taxpayer population has become more diverse over time due to demographic developments as well as expansions in the scope of the law. For example, about a fifth of the population speaks a language other than English at home, while over five percent of households consist of unmarried partners. With a tax return for every couple of people, demographic trends create a question whether the “average” taxpayer will continue to exist. Against a history of growing population and return volume, the ratio of tax returns to IRS employees has risen over the past century, while tax law complexity has increased along with automation. Consequently, accommodating the various needs of a diverse taxpayer population has become a challenge for tax administrators.

*Analysis*

Given the IRS’s mission of service as well as compliance, it can use demographic research to identify taxpayers who need specialized assistance. For example, ethnic groups with limited English proficiency and low income groups with literacy challenges may unknowingly miss substantive or procedural requirements. Similarly, elderly, disabled, or rural taxpayers who do not use the Internet may require traditional media. Certain means of communication may have the side effect of excluding distinct populations.

*Most Serious Problems*

The following Most Serious Problems relate to diverse taxpayer demographics:

- Accelerated third-party information reporting and pre-populated returns would reduce taxpayer burden and benefit tax administration but taxpayer protections must be addressed.
- The IRS should reevaluate Earned Income Tax Credit compliance measures and take steps to improve both service and compliance.
- Reinstatement of a modernized telefile would reduce taxpayer burden and benefit tax administration.
- The IRS does not sufficiently recognize and address domestic violence and abuse and its effects on tax administration.

### **13. Accelerated Third-Party Information Reporting and Pre-Populated Returns Would Reduce Taxpayer Burden and Benefit Tax Administration But Taxpayer Protections Must Be Addressed**

#### *Problem*

Much of the data taxpayers need to prepare their returns is supplied to the IRS by third-party reporting, yet is not processed or used for verification until long after taxpayers file their returns and the IRS releases refunds. With no way to timely process third-party data, the IRS unnecessarily subjects taxpayers to audits and collection actions, and spends resources trying to recover funds. Tax compliance would increase if taxpayers had timely access to third-party data to aid in the preparation of returns. While the benefits of accelerated third-party reporting are significant, concerns remain about the accuracy of the third-party data and the manner in which the IRS will adjust taxpayers' accounts based on that data. Thus, before implementing the program, the IRS must develop procedures that provide taxpayers with the standard taxpayer rights that accrue during an examination.

#### *Analysis*

To reduce taxpayer burden, the IRS should follow the lead of other domestic and international tax agencies by providing taxpayers the ability to download third-party data directly from the IRS into return preparation software and ultimately should allow taxpayers to file a pre-populated return. Both taxpayers and the IRS would benefit from the anticipated reduction in inadvertent noncompliance and associated costs. As the IRS develops the real-time tax system, the National Taxpayer Advocate has serious concerns about the protection of fundamental taxpayer rights. It is unclear whether the IRS will consider Automated Underreporter (AUR) adjustments as traditional examinations if they shift to the filing season. If not, taxpayers may lose such protections as the avoidance of repetitive and unnecessary examinations, adequate notice by the IRS, and an opportunity to contest the proposed adjustment administratively and in Tax Court. The inaccuracy of third-party data is another significant issue.

#### *Recommendations*

The National Taxpayer Advocate recommends that the IRS study information reporting and work with the Department of Treasury to develop a legislative recommendation to accelerate third-party reporting deadlines, tighten the current e-file mandate, and enable the IRS to receive Form W-2 data at the same time taxpayers receive the forms from their employers; evaluate ways to build the Information Return Master File database in real time as information returns come in; enable taxpayers to download third-party data directly from the IRS into return preparation software; evaluate the experience of other domestic and foreign jurisdictions with return-free systems; study the accuracy of third-party reporting data; develop procedures that do not include math error authority for adjustments based solely on third-party reporting mismatches; provide taxpayers the taxpayer rights that accrue during an examination; and work with the National Taxpayer Advocate to design any associated taxpayer notices in a clear and straightforward manner.

#### **14. The IRS Should Reevaluate Earned Income Tax Credit Compliance Measures and Take Steps to Improve Both Service and Compliance**

##### *Problem*

The Earned Income Tax Credit (EITC), a refundable credit for certain low income workers, lifted approximately six million people out of poverty in 2009 (the most recent year for which data are available). At the same time, the EITC is now classified as the fourth largest source of “improper payments” by the government in fiscal year 2010. It is difficult to evaluate the implications of this classification because successive estimates of improper EITC have been obscure if not incomparable. In any case, efforts to reduce improper payments should not curtail the EITC’s successes. Because EITC funds can be a vital component of a family’s basic living expenses, the EITC presents a special case in which tax administration should encourage participation as well as compliance. Moreover, the intricacies of the EITC law should be applied to each taxpayer’s facts, not to data that may afford administrative shortcuts while abridging individual rights.

##### *Analysis*

For FY 2009, the IRS estimated that 23 to 28 percent of EITC was paid improperly. The implications of this estimate are unclear because the IRS has not explained whether earlier and later estimates, while higher or lower, are based on comparable assumptions. Even if this estimate is overstated, improper payments reflect the complexity, barriers, and burdens of the EITC. IRS Publication 596, *Earned Income Credit*, designed to present “Earned Income Credit in a Nutshell” now runs 63 pages. Perhaps due in part to complexity, 66 percent of EITC returns are prepared by paid tax preparers (based on tax year 2009). The IRS contends, and the National Taxpayer Advocate agrees, that regulation of return preparers will markedly reduce improper EITC claims. Meanwhile, family situations can change from year to year, altering eligibility for the credit, and making IRS efforts to verify eligibility based on external data questionable. Finally, because the population of eligible taxpayers changes by an estimated one-third each year, one in three EITC taxpayers is always in a learning mode. Accordingly, IRS compliance strategies should incorporate a significant education component, including one-on-one education in the examination context.

##### *Recommendations*

The National Taxpayer Advocate recommends that the IRS prepare and disclose a full report on its current and prior EITC noncompliance studies; utilize external data only as an indicator for the risk of noncompliance, so that taxpayers retain the right to present their own facts; and send the plain-language version of the letter to notify taxpayers that their EITC claims are under correspondence audit and revise similar form letters.

## 15. Reinstatement of a Modernized TeleFile Would Reduce Taxpayer Burden and Benefit Tax Administration

### *Problem*

The IRS unjustifiably ended the TeleFile program in 2005. In fact, the IRS stopped publicizing the program, narrowly defined the user population by restricting eligibility, and then claimed the cost per tax return was too high. Shutting down TeleFile did not drive its users to e-filing as much as the IRS expected, because nearly 30 percent of former users filed paper returns in 2008. Without the program, millions of taxpayers have no free and convenient way to file electronically. In fact, the IRS's elimination of TeleFile and refusal to revive an expanded Telefile program have an economically and racially discriminatory impact. These actions also provide small businesses with no free and simple method to electronically file and make payments for Form 94x series returns.

### *Analysis*

By reinstating a modernized version of TeleFile, the IRS will enable both the remaining paper filers and the IRS to realize the significant benefits of electronic filing. The IRS can meet the emerging demand for phone-based services by developing an application accessible by cell phone, smartphone, or tablet. Participation rates will also increase and the cost per return will decrease if the IRS relaxes eligibility requirements.

The elimination of TeleFile and the IRS's refusal to revive an expanded program has a disparate impact on the elderly, minorities, and individuals who are in lower income brackets or have not achieved high education levels due to the lower levels of Internet usage among these populations. In addition, small businesses no longer have a free and simple option to electronically file Form 94x series returns and make payments. Considering that the filing and payment of payroll taxes is key to our voluntary tax system, the IRS should develop a free and simple telephone application, thereby reducing the burden on millions of small businesses.

### *Recommendations*

To reduce taxpayer burden and meet the needs of taxpayers as well as tax administration, the National Taxpayer Advocate recommends that the IRS reinstate the TeleFile program; relax its eligibility requirements; develop TeleFile applications for technology such as cell phones, smartphones, and tablets; and develop a modern application of TeleFile to allow small businesses to file Form 94x series returns as well as make associated payments free of charge.

## The Most Serious Problems Encountered by Taxpayers

**16. The IRS Does Not Sufficiently Recognize and Address Domestic Violence and Abuse and its Effects on Tax Administration***Problem*

One in every four women will experience violence at the hands of an intimate partner in her lifetime, and nearly three out of four Americans know someone who is or has been a victim of domestic violence. Domestic violence and abuse, including economic abuse, have real consequences for tax administration. Examples are joint returns signed under duress or without any possibility of meaningful review, and tax noncompliance in the victim's name that the victim is powerless to prevent. Identity theft may be a form of domestic abuse that allows an abusive taxpayer to "steal" tax benefits intended for the victim. Because IRS employees are not adequately trained to recognize and address domestic violence and abuse, the IRS may be complicit in achieving the wrong result — imposing or collecting tax inappropriately, or from the wrong taxpayer. Conversely, greater awareness of domestic violence and abuse would help it arrive at the correct tax result and actually alleviate harm. Moreover, the IRS lacks a centralized source of information about domestic violence and abuse and the tax problems they cause.

*Analysis*

Victims of economic abuse face unique obstacles in interacting with the IRS because they have often been kept in the dark about financial matters and prevented from managing their tax reporting and payment obligations. They may be unable to accommodate the IRS's document-oriented systems and expectations, and if they are too ashamed or afraid to disclose their abuse, IRS employees may perceive them as evasive or uncooperative. Because employees may not understand the need to solicit additional information that would help arrive at the correct tax result, communications with these taxpayers may become another barrier to relief. The Taxpayer Advocate Service has developed domestic violence training that is required for all TAS employees and is available to all IRS employees.

*Recommendations*

The National Taxpayer Advocate recommends that the IRS should require all employees who handle innocent spouse claims, all Appeals employees, all Revenue Agents, all Revenue Officers, and all SB/SE Chief Counsel attorneys to take the domestic violence training prepared by the Taxpayer Advocate Service; the IRS should work with TAS to incorporate portions, if not all, of the TAS training into all other front-line public contact employee training, at a minimum portions of the TAS training with information for employees who may be facing this issue themselves or know others who are; the IRS should develop a resource page on its internal website with information and resources for IRS employees who may be experiencing domestic violence and abuse; and the IRS, in collaboration with TAS, should develop a comprehensive communication strategy for taxpayers and government agencies, with information about domestic violence and abuse and how to resolve related tax issues, and links to nonprofit support organizations.

## COMPLIANCE ISSUES

### 17. The IRS Does Not Emphasize the Importance of Personal Taxpayer Contact as an Effective Tax Collection Tool

#### *Problem*

The IRS, in attempting to collect millions of dollars from taxpayers with delinquent accounts, concentrates its collection efforts on issuing notices without attempting to contact the taxpayer by phone or face-to-face. The IRS annually sends over 34 million notices to taxpayers in the first stage of the collection process, but the average payment received in response to a notice in fiscal year (FY) 2011 was just \$517. Cases are not always fully resolved through the notice process and accrue additional interest and penalties, but by reaching out to a taxpayer earlier in the process, the IRS may be able to answer questions, discuss payment alternatives, and reduce accrual of additional liabilities.

#### *Analysis*

The IRS collection process consists of three stages — the notice stream, the Automated Collection System (ACS), and the Collection Field function (Cff). Generally, the first two stages rely on sending notices and taking systemically-generated enforcement actions, such as issuing a levy or lien, to force the taxpayer into calling the IRS. In FY 2011, 3.7 million cases remained unresolved after the initial notice stage and moved to the ACS where the IRS traditionally spends only about three percent of its direct time making outgoing calls. According to recent data, 60 percent of the cases in ACS have been there six months or longer and are then moved into a queue where they remain until a field revenue officer is available to work them. The dollar value of cases assigned to the queue has doubled over the last six years to over \$56.2 billion at the end of FY 2011.

Personal contact with taxpayers is most often delayed until the third and final stage — Cff — when a revenue officer will attempt to contact the taxpayer in person. This final stage comes after months of delinquent taxpayer accounts languishing in either ACS or the queue. The collection industry estimates that the probability of collecting unpaid accounts falls to 70 percent after three months, 52 percent after six months, and 23 percent after a year. Businesses can accrue on average over two years of tax debt before the IRS ever attempts personal contact. The IRS has a responsibility to talk with taxpayers as early as possible to determine the reasons behind any tax liability, prevent the accrual of additional liabilities, and discuss payment alternatives.

#### *Recommendations*

The National Taxpayer Advocate recommends that the IRS conduct a test by increasing use of the predictive dialer in making personal contacts in targeted segments of the collection workload, *e.g.*, higher-dollar notice accounts, notices involving “repeat delinquents,” and potentially defaulting installment agreements and offers in compromise; revise the

## The Most Serious Problems Encountered by Taxpayers

Internal Revenue Manual to require attempted personal taxpayer contact before the ACS takes an enforcement action or sends a case to the queue; and before defaulting an existing installment agreement or establishing a new streamlined installment agreement (when the taxpayer has not indicated a monthly payment amount), attempt personal contact to determine what the taxpayer can actually pay for the new agreement or how to repair the defaulted one.

## 18. The New Income Filter for the Federal Payment Levy Program Does Not Fully Protect Low Income Taxpayers from Levies on Social Security Benefits

### *Problem*

The Federal Payment Levy Program (FPLP) is an automated system that matches IRS records against those of the government's Financial Management Service and allows the IRS to issue continuous levies for up to 15 percent of federal payments due to taxpayers who have unpaid federal liabilities. For the most part, FPLP levies have historically been imposed on Social Security benefits. In January of 2011, the IRS began applying a low income filter (LIF) to the FPLP, to screen out taxpayers who have income below 250 percent of the federal poverty level guidelines and protect these low income taxpayers from experiencing hardship due to a levy. The National Taxpayer Advocate is generally pleased with this filter, but is concerned about the criteria the IRS uses to exclude certain taxpayers from the filter, thereby leaving some taxpayers subject to the FPLP, even though their incomes otherwise fit the guidelines. The National Taxpayer Advocate also has concerns about IRS policies on bank levies, which can allow the IRS to collect all of a taxpayer's Social Security benefits.

### *Analysis*

The criteria for excluding taxpayers from the filter could allow some of them to remain subject to the FPLP — those with unfiled tax returns and those who have business tax debts (or whose spouses have them) — even if their incomes fall below 250 percent of the poverty level. The IRS determined during the development of the LIF that this level is the proxy for economic hardship. Denying the LIF filter to these taxpayers means that taxpayers whom the IRS can easily identify as low income will have 15 percent of their Social Security benefits levied. For instance, in a representative sample of 435 cases where taxpayers are subject to the FPLP and have a delinquent unfiled return, TAS found that 20.7 percent had incomes below 250 percent of the poverty level. This outcome defies logic and ignores the rationale of the *Vinatieri* case, in which the U.S. Tax Court found the IRS was wrong to levy on a taxpayer who had unfiled returns when it was clear the levy would cause economic hardship. In addition to the FPLP program, the IRS is also able to reach taxpayers' benefits by levying on taxpayers' other assets, including their bank accounts, without first considering if the taxpayer qualifies for a streamlined offer in compromise or currently not collectible (CNC) status.

### *Recommendations*

To improve the new filter, the National Taxpayer recommends that the IRS eliminate criteria that exclude taxpayers with unfiled returns or business debts from the LIF; that, before taking any further collection action against taxpayers who are subject to a 15 percent FPLP levy or have been filtered out of FPLP by the LIF, IRS employees review the case and determine if the taxpayer is a good candidate for the streamlined OIC process or meets CNC criteria; and revise levy notices to financial institutions to state that if an account holds Social Security benefits, a portion of the benefits should be exempt from the levy.

## The Most Serious Problems Encountered by Taxpayers

**19. The IRS Has Failed to Stem the Tide of Transfers to its Excess Collection File, Which Contains Billions of Dollars in Payments, and Makes Disproportionately Little Effort to Prevent Transfers from Low Income Taxpayers***Problem*

The IRS uses the Excess Collection File (XSF) to record payments and credits it has not applied to a taxpayer's account or refunded. Once these funds are transferred to the XSF, the IRS generally does not attempt to contact taxpayers to resolve the credits. In January 2010, the account held \$4.7 billion — more than double its 1999 balance. Despite four audits by the Treasury Inspector General for Tax Administration (TIGTA), a TAS analysis in the 2006 Annual Report to Congress, two IRS task force studies, and numerous recommendations to reduce the balance, the improper transfers persist, burdening taxpayers and generating costly rework for the IRS. IRS employees must attempt to personally contact taxpayers before making a transfer only if the transfer is for \$100,000 or more, even though almost all transfers are for less than \$5,000 and more than half involve low income taxpayers.

*Analysis*

TIGTA estimated more than half of the transfers to the XSF were due to IRS errors. Studies have shown that even minimal efforts to contact taxpayers could prevent improper transfers, but the IRS reserves these efforts for credits of \$100,000 or more. TAS found that almost all credits transferred between 2007 and 2010 were for less than \$5,000, and more than half the transfers for which taxpayer identification numbers were found came from low income taxpayers. The smaller the transfer, the more often the taxpayer was low income. The IRS knows it would be cost-effective to personally contact taxpayers in all cases. However, employee guidance in the Internal Revenue Manual (IRM) for researching accounts before transferring to XSF is confusing. Finally, the IRS has no performance measures or goals to monitor XSF operations.

*Recommendations*

The National Taxpayer Advocate recommends that the IRS require the same enhanced procedures currently in place for large-dollar credits for all accounts destined for transfer to XSF; develop additional guidance to prevent overpayments resulting from a levy from causing transfers to the XSF; require operating divisions to include XSF activities in their Business Performance Review reports; establish an XSF account indicator to alert employees to the amounts and years of XSF transfers; and train employees to discuss XSF transfers with taxpayers.

## TAX ADMINISTRATION ISSUES

### 20. The IRS's Failure to Consistently Vet and Disclose its Procedures Harms Taxpayers, Deprives it of Valuable Comments, and Violates the Law

#### *Problem*

The Freedom of Information Act (FOIA) requires the IRS to disclose all “instructions to staff that affect a member of the public” unless an exemption applies. The IRS does not always consistently and timely do so. This failure deprives taxpayers and their representatives of information that could help them resolve tax problems and disputes; leaves them uncertain about whether they can rely on information from IRS employees; increases the risk that the IRS will act or be perceived as acting arbitrarily and inconsistently; and deprives the IRS of valuable comments from stakeholders that could improve its procedures. A related problem is that the IRS sometimes fails to vet (or “clear”) the guidance internally as well. While we understand the need to issue instructions quickly, such shortcuts can result in ill-advised procedures that, in some cases, may violate the law.

#### *Analysis*

The IRS properly posts most instructions to staff, such as its Internal Revenue Manual (IRM), to its Electronic Reading Room on the IRS.gov website. However, in addition to omitting from its website some documents used to change procedures, the IRS:

- Sometimes changes procedures without writing them down or by issuing “alerts” on an internal system called SERP (the Servicewide Electronic Research Program) without disclosing or clearing them;
- Has no procedure for clearing frequently asked questions (FAQs); and
- Does not disclose instructions to computers (called “functional specifications”).

The IRS does not know the scope of its FOIA compliance problem because many employees author “instructions to staff” and no single IRS function regularly measures or is responsible for disclosure or clearance determinations. At the end of FY 2010, the IRM contained 1,923 sections written by approximately 646 authors. Although the IRS has decision-making tools to help authors determine if items should be disclosed, which it is working to improve, these tools could lead to under-disclosure. Moreover, the IRS does not require authors to attend FOIA training.

#### *Recommendations*

The National Taxpayer Advocate recommends the IRS assign one office the responsibility to measure and improve FOIA and clearance determinations, require all authors to attend FOIA training, and continue ongoing efforts to improve its internal decision-making tools. She also recommends the IRS disclose nonexempt functional specifications that affect the public and clear its FAQs.

## The Most Serious Problems Encountered by Taxpayers

**21. After Refund Anticipation Loans: Taxpayers Require Improved Education About Refund Delivery Options and the Availability of a Government-Sponsored Debit Card*****Problem***

The market for Refund Anticipation Loans (RALs) has sharply declined since the IRS took the much-needed step of denying information about the potential size of taxpayers' refunds to return preparers and their associated financial institutions, which marketed RALs. However, the IRS still has a long way to go to ensure that it protects taxpayers as the market evolves, and is not aggressive enough in educating taxpayers about refund delivery options. The IRS can address the taxpayer's needs for funds to pay preparation fees by developing a way, with proper safeguards, to split the refund and deposit a portion in an account owned by the preparer. In addition, the IRS can require preparers to fully and accurately inform their clients about refund delivery options, with particular emphasis on the lower cost and government-sponsored ones. Finally, the National Taxpayer Advocate believes the incorporation of Western Union's MoneyWise prepaid card in the TaxWise software, which the IRS provides to Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) organizations free of charge, provides an unfair advantage to the Western Union product and is essentially an indirect endorsement of the product by the IRS.

***Analysis***

While the most popular way to receive a tax refund by far is to have the funds direct deposited into a bank account, many taxpayers, for a variety of reasons, choose to purchase commercial refund products such as RALs. In 2010, the IRS took a significant step to protect taxpayers when it stopped providing banks and preparers with information about taxpayers' non-tax debts. While this action led to a mass exodus from the RAL market, the marketplace will eventually evolve to meet the needs of taxpayers who want refunds quickly. The IRS needs to take a proactive role in this area to protect the best interests of taxpayers and tax administration. Treasury took a big step by piloting a program that offers debit cards as a refund delivery option, but unfortunately ended the pilot due to low participation. Finally, while the IRS claims to not directly endorse any particular commercial product, it indirectly endorses Western Union's MoneyWise prepaid card when it provides the VITA and TCE sites with free CCH TaxWise preparation software, which has fully integrated the Western Union product into the software and marketing materials. Thus, the MoneyWise prepaid card has a clear advantage over competitor products that have more favorable fee structures.

***Recommendations***

The National Taxpayer Advocate recommends that the IRS enhance the "Where's My Refund" service to include more detail about delays due to compliance initiatives; educate taxpayers about reduced processing and refund delivery times resulting from new IRS technology; require CCH to immediately remove all references to the Western Union debit

## The Most Serious Problems Encountered by Taxpayers

card product from the standard TaxWise software the IRS provides free of charge to volunteer tax preparation sites; evaluate the possibility of providing taxpayers with the ability to assign a portion of refunds to preparer bank accounts with proper safeguard; partner with Treasury and the financial sector to offer a Treasury-sponsored debit card for tax refunds; and leverage its role in return preparer oversight to require preparers to accurately inform taxpayers about their refund options.

## 22. The IRS Procedures for Replacing Stolen Direct Deposit Refunds Are Not Adequate

### *Problem*

When a taxpayer's paper refund check is stolen, the IRS can ask the Treasury's Financial Management Service to issue a replacement. However, despite the growth of electronic banking and its own efforts to get taxpayers to e-file returns, the IRS has insufficient procedures for replacing stolen direct deposit refunds. An increasing number of thieves have moved from stealing refund checks from the mail to trying to direct the deposits of tax refunds to their own bank accounts. A thief may steal a paper tax return from the mail to insert his own bank account number on it, or an unscrupulous return preparer may alter the direct deposit account number on a return. In either case, the taxpayer's ultimate recourse is to pursue legal action against the thief, with no help from the IRS.

### *Analysis*

The IRS has limited ways for taxpayers to obtain a replacement refund for a direct deposit refund that was stolen. Ultimately, the IRS tells taxpayers that to receive relief, they will have to pursue legal action against the thief or otherwise seek remedy without IRS assistance.

### *Recommendations*

The National Taxpayer Advocate recommends that, to enable the IRS to reimburse victims of lost or stolen direct deposit refunds, the IRS establish procedures in consultation with the National Taxpayer Advocate that make no distinction between paper and electronic refund theft or loss; train IRS employees involved in refund processing how to recognize and correct accounts where fraud is an issue; and seek additional amounts if the fund that currently reimburses taxpayers in case of IRS error proves insufficient for the proposed reimbursement.

## Status Update: The IRS Has Made Significant Progress in Developing and Implementing a System to Register and Test Return Preparers

### *Problem*

The National Taxpayer Advocate is pleased with the progress made by the IRS in developing a program to regulate return preparers. This program is critical to enable the IRS to effectively track preparers, ensure they are competent to prepare tax returns, and coordinate all related initiatives to provide services and apply enforcement when necessary. We continue to have concerns about the limited availability of competency examinations. The IRS's National Research Program (NRP) data show a high level of underreporting noncompliance with employment taxes, business income reported on individual returns, and corporate income tax. Requiring preparers of these returns (other than attorneys, certified public accountants, and enrolled agents) to pass a minimum competency test will reduce noncompliance in these areas. We are also concerned about any delay by the IRS in conducting a taxpayer education campaign. A comprehensive public awareness campaign educating taxpayers about rules applicable to preparers and reminding taxpayers to obtain a signed copy of their returns will protect taxpayers and arm them with the knowledge they need to avoid falling victim to negligent or unscrupulous preparers.

### *Analysis*

As the IRS implemented the return preparer program, it decided to first offer only one preparer competency examination covering 1040 series returns and to exempt preparers who do not handle these returns from the exam requirement. We believe the IRS should develop additional exams in areas associated with high levels of noncompliance. The first exam should cover payroll tax issues. The payroll service provider industry prepares employment tax returns for over 1.4 million employers, and TAS Research found that for tax years 2008 and 2009, payment noncompliance rates for employment tax businesses hovered at or above 20 percent and filing noncompliance rates were approximately 15 percent. In addition, the NRP 2001 federal tax gap data estimated the employment tax gap at more than \$54 billion. The second business exam should cover complex Schedule C, corporation, and partnership tax issues. IRS data shows that approximately 88.5 percent of business returns were prepared using a paid preparer in tax year 2009. The NRP estimates the 2001 federal tax gap attributable to underreported corporation income at \$30 billion and underreported business income for individual income tax at \$109 billion. In addition, the Government Accountability Office (GAO) analyzed IRS data from the NRP study on S corporation compliance and found that 81 percent of S corporations used a paid preparer and 71 percent of those that did were noncompliant. Thus, it is imperative that the IRS develop minimum competency examinations covering more complex business tax issues.

The IRS initially focused communications on making preparers aware of the rules that apply directly to them. However, as the program progresses, the IRS should devote more

resources to informing taxpayers about the rules applicable to preparers. Taxpayers can protect themselves from unscrupulous or underground preparers if they can identify those who refuse to comply with the basic rules to register and obtain PTINs. Thus, beginning in 2012, the IRS should conduct a comprehensive public awareness campaign educating taxpayers that their paid preparer is required to enter the PTIN, sign the return, and provide a copy to the taxpayer. In addition, to reduce the number of taxpayers falling victim to fraudulent preparer practices, IRS communications should warn taxpayers about preparers who may attempt to direct deposit all or part of the taxpayer's refund into the preparer's bank account.

### *Recommendations*

The National Taxpayer Advocate recommends that the IRS develop two examinations on business topics, informed by analysis of preparer-related data, with the first exam covering payroll tax issues and the second covering corporations, partnerships and complex Schedule C items, and launch the first exam by 2014 and the second by 2015; mount a public awareness campaign, starting in the 2012 filing season, specifically reminding taxpayers that if they paid for return preparation, they should obtain a copy of the return that shows the preparer's signature and PTIN; and incorporate into filing season communications a warning to taxpayers about preparers who may attempt to direct deposit all or part of the taxpayer's refund into the preparer's bank account.

## Status Update: The IRS Makes Reinstatement of an Organization's Exempt Status Following Automatic Revocation Unnecessarily Burdensome

### *Problem*

Prior to 2006, small exempt organizations (EOs) did not have annual IRS filing obligations and could become or remain “invisible” to the IRS. The Pension Protection Act of 2006 (PPA) addressed this information gap not only by imposing an annual filing requirement on small EOs, but also by providing for automatic revocation of the exempt status of any organization failing to file for three consecutive years. In 2009, the IRS began notifying organizations subject to the new requirements when they failed to file in a single year, but did not advise them of the second consecutive such failure. In 2011, the IRS notified approximately 275,000 EOs that their tax-exempt status had been automatically revoked. The IRS does not permit administrative review of the automatic revocation, and requires public charities to submit a full Form 1023, the form used to apply for *initial recognition* of exempt status, to obtain *reinstatement*. This form takes taxpayers about two working days to complete, and can involve lengthy IRS processing times. Meanwhile, the IRS has delayed developing Cyber Assistant, a web-based software program that taxpayers will use to prepare Form 1023.

### *Analysis*

Administrative appeal is normally available to organizations whose exempt status is revoked. The IRS could have provided administrative review of automatic revocations but did not. The PPA does not prescribe any particular IRS form to apply for reinstatement; the IRS could have developed a less burdensome way of applying for reinstatement, such as a Form 1023-EZ, but did not. The IRS's use of the information it gleans from Form 1023 does not justify the added burden on taxpayers. The IRS announced in 2009 that Cyber Assistant would be available for a \$200 user fee, which represents significant savings for organizations now required to pay an \$850 user fee. The software will also help taxpayers avoid errors in completing Form 1023, which will reduce burden and cost for taxpayers and the IRS. Finally, the IRS does not notify organizations failing to file for two consecutive years that automatic revocation is imminent.

### *Recommendations*

The National Taxpayer Advocate recommends that the IRS allow administrative review of its conclusion that an organization's exempt status was automatically revoked; develop a less burdensome method for applying for reinstatement, such as a Form 1023-EZ, and should expedite the development of Cyber Assistant; and notify EOs when they have failed to file two consecutive returns or e-Postcards and that automatic revocation is therefore imminent.

## Status Update: The IRS Has Removed the Two-Year Deadline for Requesting Equitable Innocent Spouse Relief, but Further Adjustments to its Procedures in Innocent Spouse Cases are Warranted

### *Problem*

When married taxpayers file a joint tax return, they become “jointly and severally” liable for the tax shown, which means each spouse is individually responsible for the entire liability. In recognition that this sometimes produces unfair results, Congress enacted the “innocent spouse” rules. Internal Revenue Code (IRC) § 6015(f), known as “equitable” relief, is available when, in consideration of all the facts and circumstances, it would be inequitable to hold the spouse liable for the tax. A Treasury regulation requires taxpayers to request equitable relief within two years after the IRS initiates collection activity. After the Tax Court held the two-year rule invalid, and three appellate courts held that it was valid, in 2011 the IRS Commissioner announced that the IRS will no longer adhere to the two-year rule. The IRS is reviewing its procedures in innocent spouse cases, but needs to make further adjustments. The IRS does not track the frequency with which taxpayers allege they are victims of domestic violence and abuse, and does not always require employees to attempt personal contact with taxpayers before making final determinations in innocent spouse cases.

### *Analysis*

The form taxpayers use to request innocent spouse relief solicits information about domestic violence and abuse, but the IRS does not keep track of how many taxpayers indicate they are victims, or the outcomes in their cases. In addition, the IRS does not require employees to place outbound calls to taxpayers while evaluating their innocent spouse claims, unless the employee believes the information already at hand is insufficient for a determination. However, without talking to the taxpayers, the employees may not realize their information is incomplete. Personal contact may yield new information that would change the employee’s preliminary analysis, or confirm it. Either way, by speaking with the taxpayer, the employee may reach a more accurate result, have an opportunity to educate the taxpayer, and be able to resolve cases more quickly.

### *Recommendations*

The National Taxpayer Advocate recommends that the IRS track the number of taxpayers who, in seeking innocent spouse relief, indicate that they are victims of domestic violence or abuse, broken down by the number who do so on Form 8857 and those who do so by other means, and further by those who succeed in demonstrating to the satisfaction of the IRS that they were victims and those who do not and revise the IRM to require employees to attempt personal contact with the taxpayer before making final determinations in all innocent spouse case.

## Status Update: The IRS Has Significantly Improved the Accuracy of Restricted Interest Computations, but Problems with Failure-to-Pay Penalty Computations Continue to Cause Interest Errors

### *Problem*

“Restricted” interest is limited to specific time periods or rates (or is prohibited altogether) by various statutory provisions, and must be manually computed. When the IRS miscalculates the interest taxpayers owe, it may lead taxpayers to pay incorrect balances shown on IRS documents, only to be billed later for accruals of interest. Taxpayers may pay the wrong amounts without ever knowing the IRS made a mistake. The IRS does not always send statutorily mandated annual balance due statements that show the entire amount of interest owed by taxpayers whose accounts have restricted interest.

While the IRS has significantly improved its processes to avoid errors in computations of restricted interest, miscalculations of the underlying failure-to-pay (FTP) penalty continue to cause interest miscalculations. In the 2008 Annual Report to Congress, the National Taxpayer Advocate reported that computer-generated miscalculations of FTP penalties could potentially affect two million taxpayer accounts. If a miscalculated penalty is assessed, the amount of interest owed may also be misstated.

### *Analysis*

In 1993, the General Accounting Office (GAO, now the Government Accountability Office) found that errors in restricted interest computations produced inaccurate data. The restricted interest accuracy rate for the first half of fiscal year (FY) 2008 was 67.7 percent, and in 2009 the GAO reported that the IRS still had not addressed the problem. The IRS took steps to make its computations more accurate and improved its sampling method for evaluating accuracy. In 2011, the IRS reported an accuracy rate of 95 percent and GAO closed the issue as having been effectively addressed. The IRS plans to address inaccurately computed FTP penalties that impact corresponding interest computations in the next CADE 2 release.

Internal Revenue Code (IRC) § 7524 requires the IRS to tell taxpayers every year how much they owe. IRC § 6631, enacted as part of the IRS Restructuring and Reform Act of 1998, requires the IRS to tell taxpayers the amount of interest they owe and how it was calculated. Despite the interest being manually calculated, the law requires these notifications. Notification of the entire amount of the debt, including interest accruals, provides incentive to pay and minimizes the risk taxpayers will pay the incorrect amount.

### *Recommendation*

The National Taxpayer Advocate recommends that the IRS notify taxpayers of the entire amount they owe, including restricted interest, at least annually.

## Legislative Recommendations

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Section 7803(c)(2)(B)(ii)(VIII) of the Internal Revenue Code (IRC) requires the National Taxpayer Advocate to include in her Annual Report to Congress, among other things, legislative recommendations to resolve problems encountered by taxpayers.

The National Taxpayer Advocate places a high priority on working with the tax-writing committees and other interested parties to try to resolve problems encountered by taxpayers. In addition to submitting legislative proposals in each Annual Report, the National Taxpayer Advocate meets regularly with members of Congress and their staffs and testifies at hearings on the problems faced by taxpayers to ensure that Congress considers a taxpayer perspective.

This year's report offers the following recommendations:

## TAXPAYER RIGHTS

### 1. **Enact the Recommendations of the National Taxpayer Advocate to Protect Taxpayer Rights**

#### *Problem*

Over the last decade, the National Taxpayer Advocate has recommended many legislative changes that would serve to protect taxpayer rights. At a time when the IRS budget is shrinking, and resources are shifting to enforcement in order to increase revenue, taxpayer rights must be a priority. In addition to a declining budget, the IRS is faced with an increasingly diverse taxpayer base that has differing needs, education levels, income levels, and basic understanding of the tax system.

#### *Analysis*

Congress has not passed a major piece of legislation addressing taxpayer rights since the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98). Bills introduced since then in both the House and the Senate would incorporate the Taxpayer Bill of Rights (TBOR) proposed by the National Taxpayer Advocate in 2007. However, in this same intervening 13-year period, Congress has enacted over 140 new pieces of tax legislation affecting about 5,000 sections of the tax code. Using the 2007 Taxpayer Bill of Rights to organize the discussion of all of her previous recommendations, the National Taxpayer Advocate urges Congress to act to protect taxpayer rights.

#### *Recommendation*

The National Taxpayer Advocate urges Congress to enact the legislative recommendations that impact taxpayer rights as detailed in previous annual reports, beginning with the 2007 recommendation to codify a Taxpayer Bill of Rights that would explicitly detail both the rights and the responsibilities of taxpayers.

## 2. Restrict Access to the Death Master File

### *Problem*

Many identity thieves file tax returns that claim the dependency exemption and various tax credits for deceased individuals. The IRS has stopped more than 200,000 such questionable returns claiming refunds estimated at more than \$850 million. Surprisingly, the federal government itself is one source of personal information that identity thieves use. Acting under a 1980 consent judgment related to the Freedom of Information Act, the Social Security Administration created the Death Master File (DMF), which contains the full name, Social Security number, date of birth, date of death, and the county, state, and ZIP code of the last address on record for decedents. Today, many websites publish DMF information free or for a nominal fee.

### *Analysis*

The National Taxpayer Advocate is appalled that the federal government is making sensitive personal information so readily available. Perhaps most worrisome, the DMF contributes to tax-related identity theft by providing the date of birth, allowing thieves to target decedents who were minors and can be claimed as dependents. When the 1980 consent judgment was entered, identity theft was not a significant concern. Today, it not only imposes a considerable hardship on victims or their families, but costs the government money and resources. A contemporary balancing test between the public's right to the DMF data and the privacy rights of the decedents' families may yield different results than the same test applied 31 years ago. While DMF data has some legitimate users, there is a compelling public interest in keeping such information out of the public domain.

### *Recommendation*

The National Taxpayer Advocate recommends that Congress restrict access to certain personally identifiable information in the DMF.

### 3. **Mandate that the IRS, in Conjunction with the National Taxpayer Advocate, Review Any Proposed Expanded Math Error Authority to Protect Taxpayer Rights**

#### *Problem*

Internal Revenue Code (IRC) §§ 6213(b) and (g) authorize the IRS to use its math error authority to summarily assess tax and bypass normal deficiency procedures. Originally intended to apply to simple mathematical and clerical errors, math error authority has expanded to a compliance context and is used to disallow improper claims where an entry on a tax return conflicts with information from a database or other records. Recently, the Treasury Inspector General for Tax Administration (TIGTA) and the Government Accountability Office (GAO) have encouraged the IRS to expand its use of math error authority as a cost-effective way to process new items on returns. Although some of the GAO and TIGTA proposals may be appropriate, any future math error expansion must not increase taxpayer burden, erode taxpayer rights, or create IRS rework.

#### *Analysis*

The use of math error authority has become an attractive way to prevent potentially improper refunds. However, many of the provisions that generate these refunds have complicated eligibility requirements that vary according to taxpayers' facts and circumstances. The IRS should not use summary assessment procedures merely to resolve an uncertainty against the taxpayer. Using math error authority in facts-and-circumstances situations makes it more difficult to draft notices that clearly explain what has been changed and why. This lack of clarity may confuse taxpayers, which in turn can delay a taxpayer's refund or even result in the taxpayer losing his or her right to contest the adjustment in the United States Tax Court.

#### *Recommendations*

The National Taxpayer Advocate recommends that Congress require the IRS to develop math error notices that clearly describe what is being changed and why, and tell the taxpayer what steps he or she should take to contest the change. The National Taxpayer Advocate further recommends that Congress consider the following issues in connection with any future expansions of math error authority under IRC § 6213(g): confine use of math error authority to instances that are not factually complex, can be verified on accurate, reliable government databases, and do not require the IRS to analyze facts and circumstances; permit the IRS to use math error authority in conjunction with private third-party databases only where the databases are accurate and reliable and would not subject the IRS to constraints in litigation; and restrict math error authority in situations with a high abatement rate. To ensure that the IRS observes these limits, the National Taxpayer Advocate recommends that Congress require the Department of Treasury, in conjunction with the National Taxpayer Advocate, to evaluate and report to Congress on whether any proposed expansions of math error authority satisfy these criteria.

#### 4. Clarify that the Scope and Standard of Tax Court Determinations Under IRC § 6015(f) Is *De Novo*

##### *Problem*

Married taxpayers who file joint returns are jointly and severally liable for any deficiency or tax due. An “innocent spouse” statute, Internal Revenue Code (IRC) § 6015, provides for relief from deficiencies in specific circumstances as described in subsections (b) and (c), and for relief from deficiencies and underpayments pursuant to subsection (f). Taxpayers who do not obtain innocent spouse relief from the IRS may petition the Tax Court. “Scope of review” refers to the *evidence* the court will examine in reviewing the IRS’s decision. “Standard of review” refers to *how* the reviewing court will examine that evidence. The Tax Court holds that the scope and standard of its review in IRC § 6015(f) cases is *de novo*, meaning that it may consider evidence introduced at trial that was not included in the administrative record, and will consider the case anew, without deferring to the IRS’s earlier determination. The National Taxpayer Advocate agrees with the Tax Court but the IRS does not, and has instructed its Chief Counsel attorneys to continue to raise the scope and standard of review arguments in IRC § 6015(f) cases. This divergence creates uncertainty for taxpayers and consumes administrative and judicial resources.

##### *Analysis*

The IRS maintains that the scope of the Tax Court’s review in IRC § 6015(f) cases is limited to issues and evidence presented before Appeals or Examination, and that the proper standard of review is abuse of discretion. Under an abuse of discretion standard, the court reviews the IRS’s denial of relief and overturns that determination only where it is shown to be arbitrary, capricious, or without sound basis in fact. The taxpayer requesting relief bears the burden of proving that the IRS abused its discretion in denying relief. The National Taxpayer Advocate agrees with the Tax Court that IRC § 6015(e), which provides that the Tax Court has jurisdiction to “determine” the appropriate relief available under IRC § 6015, indicates that Congress intended *de novo* scope of review in IRC § 6015 cases. In view of Congress’ clarification that the Tax Court has jurisdiction over IRC § 6015(f) cases even where no deficiency is asserted, the National Taxpayer Advocate agrees that the *de novo* standard of review is also appropriate.

##### *Recommendation*

The National Taxpayer Advocate recommends that Congress clarify that the scope and standard of review in Tax Court determinations under IRC § 6015(f) is *de novo*.

## 5. Amend IRC § 6343(a) to Permit The IRS to Release Levies on Business Taxpayers that Impose Economic Hardship

### *Problem*

Longstanding IRS regulations under Internal Revenue Code § 6343(a) relieve individuals, but not businesses, from levies on the grounds of economic hardship. The IRS and Department of Treasury have not developed a standard for evaluating economic hardship with respect to businesses. Nevertheless, IRS levies can be devastating to the survival of a small business, generating economic harm for employees, suppliers, and sometimes the communities these businesses serve.

### *Analysis*

The Taxpayer Bill of Rights I, enacted in 1988, requires the IRS to release a levy upon a taxpayer's property or rights to property if it determines the levy is creating an economic hardship due to the financial condition of the taxpayer. The IRS's procedural guidance and techniques to evaluate payment alternatives for businesses focus on the business's ability to liquidate its productive assets to pay existing tax debts, rather than the impairment of a business's cash flow, to determine if it can satisfy its debts while remaining viable. IRS collection procedures do not consider how long the entity has been in business, the business's long-term compliance history, or the nature of the delinquency problem. Although the IRS should not be an unwilling partner in a business venture, it also should not cause the failure of a viable business that is exercising ordinary business care and prudence. It may be appropriate to provide additional relief by foregoing the collection of tax by levy after the IRS makes certain determinations about how a levy will affect a business.

### *Recommendation*

The National Taxpayer Advocate recommends that Congress amend IRC § 6343(a)(1)(D) to permit the IRS to release a levy against a business taxpayer where the levy is creating an economic hardship, by considering factors including the economic viability of the business, the nature and extent of the hardship (including whether the taxpayer exercised ordinary business care and prudence), and the potential harm to individuals if the business is liquidated.

## 6. Amend the Erroneous Refund Penalty to Permit Relief in Case of Reasonable Cause for Claim to Refundable Credits

### *Problem*

Even if they do not owe tax, businesses and individuals may claim a refund due to a special tax break such as one designed to support home ownership or health care. Many such breaks are refundable credits commonly known as “negative taxes” targeted at small business, low and middle-income taxpayers, who paradoxically may be challenged by the complexity of the tax law. Taxpayers who misunderstand the rules may not only be denied the credit but can be charged a penalty of up to one-fifth of the amount they claimed, even if they started with no taxable income from which to pay. To a taxpayer who has attempted to understand and comply with the tax law, being assessed a penalty for merely asking for a refund that the IRS denies adds insult to injury.

### *Analysis*

Because special tax breaks, such as the First-Time Homebuyer, Making Work Pay, health care, adoption, and American Opportunity tax credits came into being after 2007, the erroneous refund penalty legislation could not have anticipated and provided exceptions for them. By contrast, the 2007 legislation excepted the refundable credit best-known at the time, the Earned Income Tax Credit. As enacted, the erroneous refund penalty may apply not only to claims without reasonable basis but also to inadvertent errors for which a confused taxpayer may have reasonable cause. This is especially the case with respect to special tax breaks designed as refundable credits, which proliferated after 2007.

### *Recommendation*

Congress should amend the erroneous refund penalty to permit relief in case of a good faith but incorrect claim to a refundable credit if the taxpayer had reasonable cause for the error.

## 7. **Authorize the IRS Office of Appeals to Rescind Notices of Determination Issued in Collection Due Process Cases**

### *Problem*

Before the IRS can seize a taxpayer's assets or after it has filed a Notice of Federal Tax Lien (NFTL), the Office of Appeals (Appeals) is generally required to hold a Collection Due Process (CDP) hearing for a taxpayer who requests a hearing and states grounds for the hearing. Appeals officers are not required to review or consider information submitted by the taxpayer after Appeals issues the Notice of Determination (NOD) in CDP cases. In some cases, Appeals issues a NOD before the taxpayer has an opportunity to present information, because the taxpayer is unavailable at the time of the hearing, or the Appeals officer has not received information. The inability of Appeals to rescind the NOD and rehear issues may deprive some taxpayers of meaningful hearings, create a delay in resolving a taxpayer's case, and unnecessarily use Tax Court resources.

### *Analysis*

The Internal Revenue Code (IRC) does not authorize Appeals to rescind CDP NODs. Under present law, the IRS may be constrained from affording some taxpayers the opportunity for a meaningful CDP hearing. The Tax Court remands cases to Appeals when they are factually incomplete and need development, or Appeals abused its discretion, remanding 10.4 percent of its CDP cases in FY 2010. Appeals should be able to rescind CDP NODs when it determines that it did not consider or review information that could materially change the resolution in the taxpayer's determination before the taxpayer has petitioned Tax Court.

### *Recommendations*

The National Taxpayer Advocate recommends that Congress amend IRC § 6330 to permit Appeals, with the consent of the taxpayer, to rescind CDP NODs in cases where the taxpayer has raised a legitimate concern regarding the NOD within the 30-day period for petitioning the Tax Court, and before the taxpayer has requested Tax Court review.

## EFFECTIVE TAX ADMINISTRATION

### 8. Clarify that the Emergency Exception to the Anti-Deficiency Act Includes IRS Activities that Protect Taxpayer Life and Property

#### *Problem*

The Anti-Deficiency Act prohibits the IRS from conducting activity during periods of lapsed appropriations (*i.e.*, government shutdowns), except for “emergencies involving the safety of human life or the protection of property.” The IRS and the Department of Treasury position, reflected in the IRS’s shutdown contingency plan, is that the emergency life and property exception applies to agency functions that are in essence public safety or police powers. Consequently, during a government shutdown the IRS will not process paper tax returns or issue a refund that requires manual processing even if the taxpayer needs the refund to purchase medical supplies or avert interruption of utility services. The National Taxpayer Advocate believes the IRS’s shutdown contingency plan is unnecessarily restrictive and prevents it from assisting taxpayers even in emergencies involving the safety of human life or the protection of property.

#### *Analysis*

Because it is impractical to interrupt the IRS’s automated systems, the IRS contingency plan for a government shutdown provides that electronically filed returns will be processed and automated collection activity will continue. The IRS will also process payments submitted with paper returns because these receipts constitute government property. However, the IRS will not issue refunds claimed on paper returns or on e-filed returns if the refunds need manual processing, and will not operate service centers or call sites except to enable taxpayers to meet their filing obligations. With its contingency plan, the IRS has no way to ensure that taxpayers facing immediate financial hardship would receive refunds or relief from automated collection activity. Taxpayers who come to TAS may not get the assistance they need if an insufficient number of TAS or other IRS employees are permitted to continue to work.

#### *Recommendation*

The National Taxpayer Advocate recommends that Congress clarify that the emergency exception to the Anti-Deficiency Act includes IRS activity involving the safety of human life, including taxpayer life, or the protection of property, including taxpayer property. Alternatively, the National Taxpayer Advocate recommends that Congress clarify that the National Taxpayer Advocate’s authority to issue Taxpayer Assistance Orders pursuant to IRC § 7811 continues during a lapse in appropriations and includes the authority to incur obligations in advance of appropriations, and that the IRS can incur obligations in advance of appropriations to comply with any Taxpayer Assistance Order issued under IRC § 7811.

## 9. Assessment of Civil Penalties Against Preparers of Fraudulent Returns

### *Problem*

A limited number of tax return preparers have defrauded taxpayers and the IRS by altering the taxpayers' completed and signed returns without their knowledge, claiming inflated refunds that the taxpayers were not entitled to receive, and directing the excessive refunds to their own accounts. On discovering that a refund so claimed is improper, the IRS, not realizing that the return was altered without the taxpayer's knowledge, attempts to retrieve the excess refund from the unsuspecting taxpayer. The taxpayer then provides the correct return, which the IRS processes. The IRS may impose limited penalties upon the preparer, but the government must file a costly suit in court to collect the excess refund from the preparer. Thus, there is no effective civil penalty for this type of preparer fraud.

### *Analysis*

The law requires that a taxpayer filing any return declare that it is made under penalties of perjury. Where the taxpayer is unaware of the return preparer's later alteration of a signed return, the altered document actually filed is not the document that the taxpayer affirmed, and hence is not a valid return. The altered return is a nullity, and, on receiving the correct return from the taxpayer, the IRS must reverse the account entries made based upon the fraudulent return. The IRS has limited administrative authority to recoup an erroneous refund from a preparer in these circumstances. It can recover the amount paid only by requesting the Department of Justice (DOJ) to file a civil action. Such litigation, however, is costly to the government, particularly in low-dollar amount cases. The IRS can impose certain penalties against preparers for preparing returns understating tax liabilities, but those penalties are not applicable if the document filed by the preparer is not a return. Moreover, even if the IRS is able to assert a penalty (*e.g.*, penalty for diverting a taxpayer's refund via direct deposit), the amount of that penalty (\$500) is generally far below the amount received by the preparer. The remedies currently available fall short in fully recovering the erroneous fraudulent refund, and may not adequately deter preparers from engaging in fraud.

### *Recommendation*

The National Taxpayer Advocate recommends that Congress amend the Internal Revenue Code to provide that when the issuance of an erroneous refund to a return preparer is due to fraud, the IRS may impose a penalty, in addition to other penalties provided by law, equal to 100 percent of that erroneous refund. Because the penalty would be based on a finding of fraudulent activity, deficiency procedures should apply, and the IRS should have the burden of proof with respect to the penalty.

## 10. Provide Administrative Review of Automatic Revocations of Exempt Status, Develop a Form 1023-EZ, and Reduce Costs to Taxpayers and the IRS by Implementing “Cyber Assistant”

### *Problem*

On June 8, 2011, the IRS notified approximately 275,000 organizations that, under the Pension Protection Act of 2006 (PPA), their exempt status had been *automatically* revoked because they failed to file tax returns for three consecutive years. The IRS could, but does not, provide for administrative review of this conclusion. Instead, it simply advises taxpayers to contact the IRS in the event of a dispute, or to apply for reinstatement. The IRS requires organizations to fill out a full Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, to apply for reinstatement. Cyber Assistant, a web-based software program the IRS is developing, will help taxpayers prepare Form 1023 at a reduced user fee, but its release has been delayed until further notice.

### *Analysis*

The PPA imposed a new annual filing requirement on small exempt organizations (EOs; generally, those with gross receipts of \$25,000 or less) and provides that the exempt status of any EO failing to file for three consecutive years is automatically revoked. The PPA makes judicial review of automatic revocations unavailable, but does not prohibit administrative review. The law also requires “revoked” organizations to apply for reinstatement but does not specify the form they must use. The IRS requires Form 1023, which the IRS estimates takes more than two weeks to complete. Small charities, which make up most of the “revoked” organizations, could provide sufficient information on a shorter “Form 1023-EZ” if the IRS made one available. Cyber Assistant, which will help EOs prepare Form 1023 at a lower fee, is not yet available.

### *Recommendations*

The National Taxpayer Advocate recommends requiring the IRS to provide administrative review of its conclusion that exempt status was automatically revoked; requiring the IRS to develop a Form 1023-EZ; and funding and requiring the IRS to implement Cyber Assistant.

## 11. Allow Individual U.S. Taxpayers Residing Abroad the Option to Choose the Currency of Their Country of Residence as Their Functional Currency

### *Problem*

Measuring income for tax purposes can be complicated for millions of U.S. taxpayers who live abroad and are paid in foreign currency. Although they keep books and records in Euros, pesos, or other currencies, these taxpayers must translate their records into U.S. dollars to compute their U.S. tax liabilities, using the dollar as a “functional currency.” Requiring multiple computations of potential currency gains or losses even on daily transactions, coupled with fluctuations in exchange rates, creates confusion and uncertainty, makes compliance difficult, and unnecessarily burdens both taxpayers and the IRS.

### *Analysis*

The law requires individual taxpayers to use the U.S. dollar as their functional currency. Even in the simplest case, income and deductible expenses in foreign currency must be converted into U.S. dollars contemporaneously, using the prevailing exchange rate when the income or expense is paid, received, or accrued. These taxpayers may be confused by the multitude of available rates. They are subject to the additional burdens of properly substantiating volatile exchange rates and making multiple calculations for U.S. tax purposes, which differ from the tax determinations they make in local currency for their country of residence. Ascertaining U.S. tax liabilities in dollars when the taxpayers’ financial results are determined in a foreign currency can yield distorted results, especially in years of currency volatility.

### *Recommendations*

The National Taxpayer Advocate recommends that Congress amend Internal Revenue Code (IRC) § 985 to allow individual U.S. taxpayers residing abroad to adopt the local currency as their functional currency with respect to certain activities associated with their residence in a foreign country (*e.g.*, activities of a qualified residence unit or QRU), giving individuals the flexibility currently extended to business taxpayers; and to use an average exchange rate or other reasonable method of accounting to convert foreign currency into U.S. dollars in order to determine the individual’s taxable income and gain for taxpayers who do not adopt the QRU and have the U.S. dollar as their functional currency for the taxable year.

## 12. Codify the Authority of the National Taxpayer Advocate to File *Amicus* Briefs, Comment on Regulations, and Issue Taxpayer Advocate Directives

### *Problem*

The National Taxpayer Advocate is mandated to report on taxpayer problems that are the frequent subject of litigation and to identify administrative as well as legislative solutions to reduce controversy and mitigate problems. However, the National Taxpayer Advocate is neither authorized to participate in litigation, even as *amicus curiae*, nor specifically charged with making comments to which the IRS is required to respond, in the administrative rule-making process. While current law authorizes the National Taxpayer Advocate to issue a Taxpayer Assistance Order if a specific taxpayer may suffer hardship, a Taxpayer Advocate Directive to redress a flawed process affecting an entire taxpayer population is merely a creature of delegated authority within the IRS.

### *Analysis*

IRS attorneys serve the National Taxpayer Advocate as a client in both general counsel and programmatic capacities (*e.g.*, preparing reports to Congress and advising on specific taxpayer cases). However, these lawyers lack authority to draft and file *amicus* briefs on behalf of the National Taxpayer Advocate, although her independent perspective may illuminate issues before the courts. From time to time, these lawyers may comment informally on rule-making, but the IRS is not required to respond to their comments or even notify them of proposed regulations. Similarly, unlike the Taxpayer Assistance Order, no law ensures that the IRS will honor or even acknowledge a Taxpayer Advocate Directive.

### *Recommendation*

Significant taxpayer problems could be forestalled if the National Taxpayer Advocate had an official function with respect to judicial and regulatory review. An independent counsel within the Office of the Taxpayer Advocate, while contributing to mandated legislative recommendations, could help resolve problems short of legislation by executing this function. In particular, the independent counsel would advise on *amicus* briefs on behalf of the National Taxpayer Advocate in cases with precedential potential for taxpayer rights and on rule-making, where individual taxpayer concerns may otherwise escape notice. Additionally, legislation would authorize the National Taxpayer Advocate to issue a Taxpayer Advocate Directive to with respect to any IRS program, proposed program, action, or failure to act that may create a significant hardship for a segment of the taxpayer population or for taxpayers at large.

### 13. Appoint an IRS Historian

#### *Problem*

No unit of the IRS is charged with recording the history of the agency's attempts to improve tax administration, with both successes and failures. A prominent professor of tax history has bemoaned the lack of IRS history, while more dramatically, a critic has testified before the Senate Finance Committee that "the IRS shreds its paper trail, which means there is no history, no evidence, and ultimately no accountability." The record of IRS accomplishments is lost along with historical facts.

#### *Analysis*

Pre-eminent scholars have observed that while decision-makers always draw on experience, a systematic use of history can be more helpful than a merely instinctive one. This observation has not been lost on at least 29 federal agencies including all of the armed services, encompassing 11 Cabinet departments, that employ historians. In particular, popularizing the history of IRS accomplishments can be a productive aspect of civic education.

#### *Recommendation*

Create a permanent position within the IRS for a historian with expertise in federal taxation as well as archival methods. Mandate that the IRS historian record history objectively, accurately, and without deletion. To ensure historical expertise regardless of contemporary IRS policies, align the appointment with the Archivist of the United States rather than the Commissioner of Internal Revenue.

## The Most Litigated Issues

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Internal Revenue Code (IRC) § 7803(c)(2)(B)(ii)(X) requires the National Taxpayer Advocate to include in her Annual Report to Congress the ten tax issues most litigated in the federal courts, classified by the types of taxpayers affected. The cases we reviewed were decided during the 12-month period that began on June 1, 2010, and ended on May 31, 2011. This report also contains a brief discussion of an ongoing TAS study of Earned Income Tax Credit (EITC) cases where the IRS settled or conceded the EITC issue, but only after the case was already in the United States Tax Court. In addition, this section includes a discussion of certain judicial decisions that did not involve one of the ten most frequently litigated issues but were significant due to their potential impact on tax administration.

### Characteristics of EITC Cases that the IRS Fully Concedes in Tax Court

The Most Litigated Issues discussion does not take into account the Tax Court cases that are settled each year without being litigated. In fiscal year (FY) 2001, the Tax Court closed 13,600 cases. By FY 2010, the number had risen to 30,900, a 127 percent increase. However, only a small percentage of cases (fewer than three percent every year since 2007) are closed as a result of a trial and decision. More than 75 percent of closed cases every year since 2007 consists of settlements.

Decision documents for settled cases sometimes show that there was no deficiency in tax — in other words, the IRS apparently conceded the case in full. TAS is undertaking a study, *Characteristics of EITC Cases that the IRS Fully Concedes in Tax Court*, which will focus on these cases, specifically those in which the disallowed Earned Income Tax Credit (EITC) was an issue. The research question this study will attempt to answer is why the IRS conceded only after the taxpayer petitioned Tax Court.

### Significant Cases

The purpose of this section is to describe certain judicial decisions that generally do not involve any of the ten Most Litigated Issues, but nonetheless highlight important issues relevant to tax administration. This year we discussed nine cases, including two from the United States Supreme Court, four from the United States Tax Court, two from United States Courts of Appeals, and two from United States District Courts.

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

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

## The Most Litigated Issues

A person who has a summons served on him or her may contest its legality if the government petitions a court to enforce it. If the IRS serves a summons on a third party, any person entitled to notice of the summons may challenge its legality by filing a motion to quash or by intervening in any proceeding regarding the summons. Generally, the taxpayer has a difficult burden to establish the illegality of the summons. We reviewed 132 federal court cases that included issues of IRS summons enforcement. The parties contesting the summonses prevailed in full in only five cases, with six cases resulting in split decisions, and the IRS prevailing in the remaining 121 cases.

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

IRC § 162 allows taxpayers to take deductions for ordinary and necessary trade or business expenses that are paid or incurred during the course of a taxpayer's taxable year. Some of the most common issues litigated in cases involving trade or business expenses include whether the taxpayer could substantiate the expenses, whether expenses were business or personal expenses, and whether the taxpayer could establish that he or she was carrying on a trade or business. This year we identified 107 cases involving a trade or business expense issue. The courts affirmed the IRS position in the majority (approximately 53 percent) of cases, while taxpayers prevailed fully about seven percent of the time. The remaining cases resulted in split decisions. In contrast to the other Most Litigated Issues this year, taxpayers appearing *pro se* in cases involving trade or business expenses experienced a substantially higher success rate — 58 percent — than represented taxpayers, who only prevailed 39 percent of the time.

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

CDP hearings provide taxpayers with an independent review by the IRS Office of Appeals (Appeals) of the decision to file a Notice of Federal Tax Lien (NFTL) or the IRS's proposal to undertake a levy action. In other words, a CDP hearing gives taxpayers an opportunity for a meaningful hearing before the IRS issues its first levy or immediately after it files its first lien with respect to a particular tax liability. At the hearing, the taxpayer has the statutory right to raise any relevant issues related to the unpaid tax, the lien, or the proposed levy, including the appropriateness of collection action, collection alternatives, spousal defenses, and under certain circumstances, the underlying tax liability.

Taxpayers have the right to judicial review of Appeals' determinations provided that they timely request the CDP hearing and timely petition the United States Tax Court. CDP has appeared as one of the Most Litigated Issues every year since 2003. However, the number of CDP cases has dropped significantly for the second year in a row — from 170 in 2009, to 131 in 2010, to 89 in 2011.

## The Most Litigated Issues

**4. Failure to File Penalty Under Internal Revenue Code Section 6651(A)(1) and Failure to Pay Estimated Tax Penalty Under Internal Revenue Code Section 6654**

The IRS must impose the failure to file penalty if a taxpayer fails to file a return before its due date (including extensions) unless the failure was due to reasonable cause and not willful neglect. The estimated tax penalty is also a mandatory penalty and applies when a taxpayer does not pay the required installment of estimated tax, unless the individual can meet one of the statutory exceptions. In any court proceeding, the IRS has the initial burden of providing sufficient evidence that it appropriately imposed either of these penalties.

This year we reviewed 74 cases involving the failure to file penalty, the estimated tax penalty, or both penalties. Thirty-two cases involved imposition of the estimated tax penalty in conjunction with the failure to file penalty, two cases involved only the estimated tax penalty, and the remaining 40 cases involved only the failure to file penalty. The IRS won the majority of the 74 cases, with the taxpayer only winning three cases and split decisions numbering only three.

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

When preparing tax returns, taxpayers must complete the crucial calculation of gross income for the taxable year to determine the tax they must pay. The gross income cases analyzed in this report include issues that most often fall into two categories: (1) what is included in gross income under IRC § 61, and (2) what can be excluded under other statutory provisions. For this report, we reviewed 62 cases, with issues that include:

- Damage awards;
- Discharge of indebtedness;
- Parsonage income; and
- Gain from sale of principal residence.

Of these cases, the IRS prevailed in 53 cases, while the taxpayer only won four cases and five resulted in a split decision.

**6. Accuracy-Related Penalty Under Internal Revenue Code Sections 6662(B)(1) and (2)**

IRC §§ 6662(b)(1) and (2) authorize the IRS to impose a penalty if a taxpayer's negligence or disregard of rules or regulations caused an underpayment of tax, or if an underpayment exceeded a computational threshold, called a substantial understatement. IRC § 6662(b) also authorizes the IRS to impose three other accuracy-related penalties. We did not analyze these other accuracy-related penalties because during our review period, taxpayers litigated these penalties less often than the negligence and substantial understatement penalties.

Cases with accuracy-related penalty issues decreased substantially this year, from 125 in 2010 to 55 in 2011, a 56 percent reduction. Of the cases this year, the IRS won 36, taxpayers won 14, and five cases resulted in split decisions.

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

IRC § 7403 authorizes the United States to file a civil action in a United States District Court against a taxpayer who has refused or neglected to pay any tax, to enforce a federal tax lien, or to subject any of the delinquent taxpayer's property to the payment of the tax. We identified 48 opinions that involved civil actions to enforce federal tax liens under IRC § 7403. The courts affirmed the position of the United States in the majority of cases, as taxpayers prevailed in only three cases and three others resulted in split decisions. This is the third year that this issue has appeared as a Most Litigated Issue in the Annual Report.

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

Married couples may elect to file their federal income tax returns jointly or separately. Spouses filing joint returns are jointly and severally liable for any deficiency or tax due. Joint and several liability permits the IRS to collect the entire amount due from either taxpayer. IRC § 6015 provides three avenues for relief from joint and several liability. Section 6015(b) provides "traditional" relief for deficiencies. Section 6015(c) also provides relief for deficiencies for certain spouses who are divorced, separated, widowed, or not living together, by allocating the liability between the spouses. Section 6015(f) provides "equitable" relief from both deficiencies and underpayments, but only applies if a taxpayer is not eligible for relief under IRC § 6015(b) or (c).

We reviewed 43 federal court opinions involving relief under IRC § 6015 as well as one decision, *Jones v. Commissioner*, issued just after the review period. As we found last year, the most significant issue the courts addressed is the period of time within which a taxpayer can request relief under IRC § 6015(f). Ultimately, the controversy surrounding the validity of a Treasury regulation that imposes a two-year deadline for requesting equitable relief was resolved when the IRS announced that the regulation will be revised to remove the two-year time limit. Of the 44 cases we analyzed, the IRS won 24, the taxpayer won 14, and six decisions were split.

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

The frivolous issues penalty and related penalties are imposed against taxpayers for maintaining a case primarily for delay, raising frivolous arguments, unreasonably failing to pursue administrative remedies, or filing a frivolous appeal. The Tax Court or a United States District Court raised IRC § 6673 *sua sponte* in a number of cases.

During the 12-month review period, the federal courts decided at least 43 cases involving the IRC § 6673 “frivolous issues” penalty, and at least one case involving an analogous penalty at the appellate level. In many of these cases, taxpayers escaped liability for the penalty but were warned they could face sanctions for similar conduct in the future. Of the 44 cases analyzed, the IRS prevailed in 26 cases, while the taxpayer won 18 cases, including those where the taxpayer only received a warning.

#### 10. Charitable Deductions Under Internal Revenue Code Section 170

Subject to certain limitations, taxpayers can take a deduction from their adjusted gross income for contributions of cash or other property to charitable organizations. Taxpayers must contribute to certain qualifying organizations, and are required to substantiate contributions of \$250 or more. Litigation generally arises over one of four issues:

- Whether the organization receiving the contribution is charitable in nature;
- Whether the property contributed qualifies as a charitable contribution;
- Whether the amount deducted equals the fair market value of the property contributed; and
- The extent to which the taxpayer has substantiated the contribution.

We reviewed 27 cases with charitable deductions as a contested issue. The IRS prevailed in 22 cases (81 percent) and there were five split decisions. Taxpayers appeared *pro se* in 13 of the 27 cases (48 percent).

## Volume 2: TAS Research and Related Studies

### 1. **From Tax Collector to Fiscal Automaton: Demographic History of Federal Income Tax Administration, 1913-2011**

#### **Background**

Study of almost one hundred years of federal income tax administration reveals two trends. On one hand, the U.S. population as a whole grew, coupled with an increase in the percentage of the population required to file tax returns. On the other hand, the number of returns per Internal Revenue employee increased, not keeping pace with taxpayer population growth until the middle of the century. These trends were facilitated by automation.

The automation of tax administration underlies the shift of revenue collection from an elite to a popular base, which has been famously titled in legal history as a transformation from “Class Tax to Mass Tax.” What began as taxpayer interaction with local collectors became impersonal over the century.

#### **Analysis**

Taking the last 98 years under the federal income tax law in four parts, the period started with 1913 enactment, proceeded to 1939 codification, followed by 1954 recodification, and concluded with 1986 recodification and reform. In the end, this history poses questions for the future of tax administration.

#### ***Establishment of Income Tax as a “Class” Tax, 1913-1938***

In 1913, Congress enacted a highly progressive income tax. This locally administered tax helped fund the American effort in World War I, and sustained the government during the Great Depression.

#### ***Transformation into a “Mass” Tax, 1939-1953***

In 1942, a sweeping legislative transformation to fund the next war effort turned the mass of the populace into income taxpayers. Wartime popularization resulted in “a marriage of convenience that survived” between the American people and the income tax. The war revenue measure persisted into peacetime, forming a permanent national infrastructure.

#### ***Automation and Meltdown, 1954-1985***

Post-World War II modernization proceeded along the lines of a centralized reorganization announced in 1952 as a dramatic break from a tradition of local collectors, which had become corrupted over time by bribery and its ilk. Centralization facilitated technological advancement in Service Centers and similar new sites. There, central processing proceeded in volumes that ultimately induced a computer and management meltdown in 1985. Thus, the risk associated with centralization appeared in this period.

### *Restructuring and an Emerging New Mission, 1986-2011*

An accumulation of refundable credits in the last quarter century, after the 1975 enactment of the Earned Income Tax Credit (EITC), added disbursement to the IRS's role of revenue collection. In 1998, legislation eliminated vestiges of local administration by restructuring the IRS into functional divisions (each with nationwide scope). Modernized after the meltdown, IRS computer systems generated results like an automaton, without the intervention of human judgment. The uniformity of the mass tax thus arrived at an extreme.

### **Conclusion with Recommendations**

In short, the IRS started as a revenue bureau but now administers social expenditures as well, through highly automated systems. Automation, with standard forms and procedures, was necessitated by the return volume of the mass tax introduced in 1942. As described by early 20<sup>th</sup>-century sociologists, formal standardization allowed government offices to administer a large volume of cases efficiently and dispassionately but at a cost of substantive discretion, "without regard for persons" in a "dehumanized" manner.

Automation was compounded by geographic centralization of command designed to combat local corruption. This combination of automation and centralization posed the question of whether the tax system had grown into a conglomerate beyond controls that could eliminate the risk of meltdown. Over time, this tax system was increasingly characterized by complexity. Ironically, complex, centralized automation could seem inappropriate in some respects for late 20<sup>th</sup> and early 21<sup>st</sup>-century mandates to deliver benefits to a diversity of targeted populations (such as low income workers qualifying for the EITC).

The lessons of history include the mid-century effort to popularize the income tax as well as reliance on automation, all in the context of a diversifying taxpayer base. History poses a question whether steadily increasing volume can be addressed simply by more automation, which presumably would work if taxpayers were uniform, or if increased diversity along with increased volume raises qualitatively different challenges.

Generally, history can be useful if studied systematically. Toward that end, Volume 1 of this report contains a Legislative Recommendation: *Appoint an IRS Historian*. Likewise, taxpayer diversity can be understood if studied systematically. Accordingly, Volume 1 in the Most Serious Problems section contains an Introduction to Diversity Issues: *The IRS Should Do More to Accommodate Changing Taxpayer Demographics*, with associated recommendations.

## 2. **An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights**

In the 2008 Annual Report to Congress, the National Taxpayer Advocate discussed concerns about the suitability of the IRS examination process, and questioned whether audit results reflect a correct determination of tax or a taxpayer's inability to navigate the system. Instead of focusing on meeting taxpayer needs and increasing personal communication to determine the correct tax liability, the IRS increased its use of automated, streamlined examination processes and reduced personal contacts. In fiscal year (FY) 2010, 86 percent of individual audits were conducted by correspondence, and 42 percent concluded with no personal contact with the IRS whatsoever. The examination process has become so removed that more than 25 percent of the EITC taxpayers surveyed for a TAS Research study were not even aware the IRS had audited their returns.

The IRS is continuing to expand its automated examination, and examination-like procedures. It recently began to expand "audit coverage" using Accounts Management employees (instead of Examination employees) to "audit" cases previously considered "below tolerance" for Examination. In addition, in FY 2010 the IRS made about 15 million contacts that many taxpayers may regard as examinations because they involve IRS attempts to match third-party income reporting to the return filed, or correct an error or omission. The IRS has taken the position that these contacts do not constitute an examination because the IRS is not examining books or records but merely asking the taxpayer to explain a discrepancy. By designating this contact as "not an examination," the IRS does not trigger a taxpayer's right to avoid unnecessary examinations and reserves the right to examine the books and records later. The National Taxpayer Advocate is concerned that these new streamlined procedures bypass key taxpayer rights the IRS routinely provides to taxpayers subject to "real" examinations.

There is no doubt that the IRS needs automation to administer tax laws and tax-based social programs efficiently. However, instead of looking forward to identify new ways of doing business, the IRS examination strategy relies on outdated communication methods that do not meet the needs and preferences of taxpayers. The future of examination requires the IRS to use automation and technology in a way that benefits taxpayers. For example, the implementation of a virtual face-to-face audit appointment system could increase communications and provide prompt, personal auditor contacts that could ultimately reduce expensive downstream compliance costs such as repeat contacts, appeals, audit reconsiderations, and the assistance of the Taxpayer Advocate Service.

The purpose of this analysis is to look at the IRS examination strategy and identify ways to use the audit process to protect taxpayer rights, increase compliance, and preserve IRS credibility. This study indicates that a more effective examination strategy must include a greater emphasis on taxpayer communication and provide that every audit, or similar examination process, no matter the dollar amount involved, must instill and protect due process and taxpayer rights.

The National Taxpayer Advocate challenges the IRS to ensure that for every audit, or similar examination process, no matter the dollar amount involved, the IRS should:

1. In light of the information available in the 21<sup>st</sup> century, review and reassess the audit processes deemed “not an examination” and instead use the audit process to protect taxpayer rights, increase compliance, and preserve IRS credibility.
2. Provide a clear, concise, and understandable initial contact letter that places taxpayers on notice as to whether they are under audit and explains the rights associated with the process.
3. Whenever possible, verbally discuss the audit process and appeal rights with the taxpayer during the first interview to ensure that the taxpayer understands the process, what he or she needs to do, and his or her appeal rights.
4. Train all examiners in the tax law, not just IRS publications, so they are capable of and comfortable with discussing issues and the basis for determinations with taxpayers and practitioners.
5. Revisit the definition of “computer-generated letter,” provide taxpayers with direct contact information for the assigned examiner, and permit taxpayers to contact and discuss the case with one examiner who will work that case to resolution.

Additionally, the National Taxpayer Advocate offers the following specific recommendations to the correspondence examination program to meet taxpayer needs and preferences and in doing so maximize compliance:

1. Conduct a comprehensive review of the work of correspondence examination and its staffing needs, today and in the future — and determine how to best incorporate virtual service delivery and other technologies such as a remote office audit to facilitate better interaction and service to taxpayers.
2. Whenever reasonable, use the term “audit” in place of “examination.” Words like “review” or “exam” confuse taxpayers. “Audit” alerts the taxpayer to the importance of the IRS action.
3. Limit correspondence audits to returns with specific, clear-cut issues. Returns requiring income probes or issues that generally require voluminous records, such as employee business records, are best handled by Tax Compliance Officers in an office or field setting.
4. Include in all correspondence involving determinations the name, telephone number, and unique identifying number of the IRS employee making the determination, as required by RRA 98.
5. Reinstate procedures under which, if they would benefit the taxpayer, one IRS employee is assigned to handle a case until it is resolved.

6. Test the ability to establish a telephone audit appointment, where an examiner can hold an initial interview, explain the examination process and appeal rights, discuss documentation, and define the next steps.
7. Redesign correspondence audit letters to increase comprehension, reduce redundant phone calls, and meet the requirements of the Plain Writing Act of 2010.
8. Improve training for Tax Examiners and provide them the technical guidance they need to be completely comfortable handling calls and inquiries.
9. Update the transfer request guidance to bring the regulation into conformity with the structure in place for more than a decade and describe situations where a request for a face-to-face audit is appropriate and will be considered.
10. Institute a technical review process to preserve the “presumption of correctness” of the Statutory Notice of Deficiency and resulting assessments. The review should focus on making sure the correct amount of tax is assessed against the correct taxpayer only after full consideration and discussion of any documentation submitted.

### 3. Estimating the Impact of Liens on Taxpayer Compliance Behavior and Income

#### Introduction

The Notice of Federal Tax Lien (NFTL) is a legal tool the IRS uses to facilitate the collection of unpaid tax debts. The IRS must file an NFTL in the appropriate location, such as a county register of deeds, 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.

While NFTL filings fell to an all-time low after the enactment of the Revenue and Reconciliation Act of 1998, they have since increased, and have risen precipitously since 2005. In fact, the 2011 volume of 1,042,230 filings is about six times the number for 1999.

Despite the 2011 "fresh start" initiative to help financially struggling taxpayers, the IRS continues to file most NFTLs based on a threshold amount of liability rather than considering taxpayers' individual circumstances and financial situations. The National Taxpayer Advocate is concerned that the IRS's use of the NFTL may be harming taxpayers, especially those with economic hardships, while not significantly enhancing the IRS's ability to collect delinquent liabilities. The National Taxpayer Advocate therefore requested that TAS Research & Analysis investigate the impact of NFTLs on the compliance behavior of delinquent taxpayers.

#### Methodology

To study the impact of the NFTL on compliance behavior, TAS Research analyzed a cohort of delinquent individual tax return filers (*i.e.*, those who file Forms 1040, *U.S. Individual Income Tax Return*) who incurred unpaid individual tax liabilities in 2002 and had no such liabilities at the beginning of that year. We identified the subgroup of these taxpayers against whom IRS filed liens between 2002 and 2004, as well as a comparable subgroup against whom the IRS did not file liens. We compared the payment and filing compliance behavior of these two groups from inception of the liability through 2010, and examined the impact that lien filings had on taxpayers' incomes during this period.

#### Findings

Our research shows that lien filing was associated with negative outcomes for payment compliance behavior on the taxpayers' initial liabilities, negative filing compliance behavior, and negative impacts on the amount of income earned by taxpayers in years after the NFTL. Lien filing did have a positive effect on taxpayer payment compliance behavior on liabilities subsequent to their original ones.

Specifically, we found that in 2005 (our first study end point) taxpayers with liens were about 6.4 percent less likely to reduce their initial liabilities than comparable non-lien taxpayers, and that through 2008, at least four years after the liens were filed, taxpayers with liens were still over five percent less likely to reduce their initial liabilities. In addition, lien

taxpayers were less likely to file required returns, with the increased likelihood of non-filing ranging between about one and three percent during the full study period (through 2010). Also, lien taxpayers were less likely to have an increase in their total positive incomes (TPI), with the increased likelihood of negative outcomes starting at about 7.9 percent and gradually declining to about 5.2 percent by the end of the full study period. It should be noted that we did not adjust dollars for inflation. Therefore, the nominal decreases taxpayers experienced in TPI at the end of the study period (*i.e.*, 2010) relative to their 2002 TPI are greater in real terms than equivalent nominal losses experienced earlier in the period.

The positive effect for lien filing on future payment compliance started at about 5.6 percent and gradually declined to about 1.2 percent by the end of the study period (2010). It is unknown if the lien filing actually improves subsequent payment compliance or if the lien filing is merely reducing the likelihood that a taxpayer will report subsequent liabilities, since the lien filing also shows a negative effect on subsequent filing compliance.

In general, the results for our models show that as the time increased, the impact associated with lien filing tended to decline.

### Next Steps

The outcome measures discussed above may be interrelated. For example, declines in TPI may affect taxpayers' ability to pay down their tax liabilities. Conversely, lien filing may motivate taxpayers to stay current with new liabilities. More generally, existing tax liabilities may motivate both lien and non-lien taxpayers to become non-filers to avoid incurring additional liabilities, but may impact lien taxpayers more because they have larger liabilities or less ability to pay due to decreased TPI. These are all possible areas for future research.

TAS will conduct additional research in 2012 to investigate when NFTLs are likely to be most effective. Possible areas of future research, in addition to those mentioned above, include the impact of lien filing on taxpayers in currently not collectible status, and whether removal of these taxpayers from our study cohort would significantly improve compliance outcome measures for the remaining lien taxpayers. We may also investigate whether lien filing is more effective for taxpayers who have significant assets. Finally, we may build on previous research and further explore the extent to which payments credited to lien taxpayers were attributable to sources other than the lien.

Although our results show that IRS lien filing practices during the study period were generally not productive for either the IRS or taxpayers, we expect that lien filing can be an effective collection tool when the IRS makes filing determinations after careful consideration of each taxpayer's individual circumstances and financial situation.

#### 4. **Math Errors Committed on Individual Tax Returns: A Review of Math Errors Issued for Claimed Dependents**

##### **Introduction**

Math error authority allows the IRS to correct some types of errors on returns and send notices to taxpayers explaining the changes. It requires taxpayers who do not agree with the correction to respond within a specified time and request an abatement of tax. However, if the taxpayer fails to request abatement timely, the IRS may collect the additional tax.

The IRS processed 141 million individual tax returns in 2010, many of which contained errors in computations or lacked information necessary to process the return. Using its math error authority to correct these errors during processing, the IRS issued more than 11.8 million math errors, some resulting in smaller refunds than the taxpayers originally claimed. The number of math errors flagged by the IRS has increased over time. In fact, from 2005–2010, the number of math errors has increased by more than 150 percent or by about seven million errors. These errors tend to rise substantially in years following significant tax law changes.

Hundreds of thousands of taxpayers receive math error notices for failure to provide a correct Taxpayer Identification Number (TIN) for a dependent, but a significant number subsequently prove to the IRS that they properly claimed the exemptions and associated tax credits. Once the taxpayer has proven that he or she properly claimed the credit, the IRS is obligated by law to reverse its math error corrections and issue any resulting refunds to the taxpayers.

##### **Findings**

TAS studied a statistically valid sample of tax year 2009 accounts in which the IRS reversed its math error adjustments related to dependent TINs. The research identified all individual accounts that had received any one of the three standard math error notices related to incorrect or missing dependent TINs affecting the dependency exemption and related non-refundable credits or the additional child tax credit, or the Earned Income Tax Credit.

For tax year 2009, nearly 300,000 returns contained errors with dependent taxpayer identification numbers. On average, one dependent TIN error was made per return, and the vast majority of these returns were filed on paper forms. More than half of these returns included a married filing joint filing status and another 28 percent used head of household status. About half of the returns were prepared by the taxpayer and the other half by paid preparers.

In the cases studied for tax year 2009, the IRS subsequently reversed at least part of its dependent TIN math errors on 55 percent of the returns with incorrect TINs. In other words, the IRS denied part of the taxpayer's claim when initially processing the return. However, when later contacted by the taxpayer, the IRS reinstated many credits originally claimed by the taxpayer. The IRS disallowed over \$200 million of credits claimed on returns with

incorrect dependent TINs. Ultimately, about 150,000 taxpayers had their refunds restored to them. On average, the IRS subsequently allowed nearly \$2,000 per return after the initial disallowance, with a delay of nearly three months.

The results of our sample review show that the IRS had the information necessary to resolve 56 percent of these 2009 dependent TIN math errors and could have avoided making a math error adjustment. This would have significantly reduced taxpayer burden. Using readily available information to resolve TIN errors would have prevented math error notices and delays in releasing nearly 75,000 refunds. Additionally, the IRS paid more than \$2.3 million in interest for corrected math errors relating to incorrect dependent TINs for tax year 2009.

TAS's study also found that a portion of taxpayers who appear to have valid dependent TINs, never reply to the IRS math error notice, and are actually entitled to dependent related exemptions and credits which they never receive. TAS reviewed a sample of 105 cases that had a math error for missing or incorrect dependent TINs (notice codes 605 or 743) and had no refund issued. TAS found that 38 percent of these cases had either received a refund after TAS pulled its original sample or the adjustment was made but the refund was either offset or the balance due was reduced. However, 62 percent of the sample still had no adjustment.

TAS determined that the IRS could have corrected and allowed all of the dependent TINs in 41 percent of the cases that still had no adjustment, if the IRS had examined its own records. It could have corrected at least one of the dependent TINs in another 11 percent of these cases. These sample percentages translate into over 40,000 taxpayers who may not have received refunds they were entitled to. Further, these 40,000 taxpayers lost at least \$44 million related to disallowed dependent TINs, or an average of \$1,274 per taxpayer.

### Recommendations

The National Taxpayer Advocate recommends that the IRS change its procedures to require that in cases of incorrect dependent TINs, employees conduct internal research to resolve these deficiencies before using math error authority to deny dependency exemptions and associated credits. The National Taxpayer Advocate further recommends that the IRS apply the methodology presented in this study to examine all math errors with significant volume and significant reversal rates to determine how it might expeditiously resolve such deficiencies rather than exercise its math error authority to deny taxpayer claims, thereby burdening taxpayers and creating IRS rework.

## 5. Analyzing Pay-As-You-Earn Systems as a Path for Simplification of the U.S. Tax System

On numerous occasions, the National Taxpayer Advocate has identified the complexity of the Internal Revenue Code as the most serious problem facing taxpayers and the IRS, and urged Congress to simplify it. According to a TAS analysis of IRS data, U.S. taxpayers and businesses spend about 6.1 billion hours a year complying with the filing requirements of the Code.

The current tax system is driven by taxpayers' desire for a timely refund and the requirement that almost all individuals file tax returns, both of which result from imprecise withholding. As stated in the 2010 Annual Report to Congress, individual taxpayers find return preparation so overwhelming that about 60 percent pay preparers to do it for them. Among unincorporated business taxpayers, the figure rises to about 71 percent. Another 29 percent of individual taxpayers use tax preparation software that can cost \$50 or more.

In 2009, the National Taxpayer Advocate identified the additional problem of the IRS processing information returns after tax returns, which leads the IRS to accept incorrect returns and issue incorrect refunds to taxpayers. Because the IRS must try to stop fraudulent refunds from going out, many returns are delayed for months while the IRS attempts to verify the information. For taxpayers relying on a substantial refund to meet basic living expenses, these delays can cause extreme hardships.

The current filing system also results in the IRS using math error authority when it discovers mistakes on returns after the fact. Math error authority allows the IRS to summarily assess a tax without first giving the taxpayer the option to challenge the tax in Tax Court. A math error assessment can result in an insurmountable tax debt because the IRS may not discover the problem until after it pays the taxpayer's refund for the entire year.

The requirement for individuals to file annual returns and the urgent need to pay out annual refunds make it difficult, if not impossible, to solve these problems without altering the current withholding system. For these reasons, and in pursuit of simplification, the National Taxpayer Advocate has commenced a comprehensive study of Pay-As-You-Earn (PAYE) systems around the world, which will analyze different methods of withholding and potential benefits of and obstacles to their use in the United States.



