

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**

Volume One



**YOUR VOICE AT THE IRS**

December 31, 2011



National Taxpayer Advocate

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TAXPAYER  
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TAXPAYER  
**ADVOCATE**  
SERVICE

YOUR VOICE AT THE IRS

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*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.

<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 21st 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 compliance tax 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

# National Taxpayer Advocate 2011 Annual Report to Congress

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## Introduction: The Most Serious Problems Encountered by Taxpayers

Internal Revenue Code (IRC) § 7803(c)(2)(b)(ii)(III) requires the National Taxpayer Advocate to prepare an Annual Report to Congress which contains a summary of at least 20 of the most serious problems encountered by taxpayers each year. For 2011, the National Taxpayer Advocate has identified, analyzed, and offered recommendations to assist the IRS in resolving 22 such problems. This year's report also includes status updates on four issues previously raised by the National Taxpayer Advocate or addressed in previous Annual Reports. Among these is an update on the registration of tax return preparers, which the National Taxpayer Advocate has recommended since the 2002 report.<sup>1</sup>

As in earlier years, this report discusses at least 20 of the most serious problems encountered by taxpayers — but not necessarily the top 20 most serious problems. That is by design. Since there is no objective way to select the 20 most serious problems, we consider a variety of factors when making this determination. Moreover, while we carefully rank each year's problems under the same methodology (described immediately below), the list remains inherently subjective in many respects.

To simply report on the top 20 problems would pose many difficulties. First, in doing so, it would require us to repeat much of the same data and propose many of the same solutions year to year. Thus, the statute allows the National Taxpayer Advocate to be flexible in selecting both the subject matter and the number of topics to be discussed, and to use the report to put forth actionable and specific solutions instead of mere criticism and complaints.

### Methodology of the Most Serious Problem List

The National Taxpayer Advocate considers a number of factors in identifying, evaluating, and ranking the most serious problems encountered by taxpayers. The 22 issues and the four status updates in this section of the Annual Report were ranked according to the following criteria:

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

<sup>1</sup> See National Taxpayer Advocate 2009 Annual Report to Congress 41-69; National Taxpayer Advocate 2008 Annual Report to Congress 503-512; National Taxpayer Advocate 2006 Annual Report to Congress 197-221; National Taxpayer Advocate 2005 Annual Report to Congress 223-237; National Taxpayer Advocate 2004 Annual Report to Congress 67-88; National Taxpayer Advocate 2003 Annual Report to Congress 270-301; National Taxpayer Advocate 2002 Annual Report to Congress 216-230; *Fraud in Income Tax Return Preparation: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 109th Cong. (2005) (statement of Nina E. Olson, National Taxpayer Advocate).

- Taxpayer Advocate Management Information System (TAMIS) and Systemic Advocacy Management System (SAMS) data.

After reviewing this ranking, the National Taxpayer Advocate identifies the issues that are, in her judgment after taking into consideration all of the above factors, the ones most in need of attention and thus requiring the most prominent placement in the ranking. Finally, the National Taxpayer Advocate and the Office of Systemic Advocacy examine the results of the ranking on the remaining issues and adjust it where editorial or numeric considerations warrant a particular placement or grouping. This year, 15 of the 22 problems — five revenue protection issues, six international issues, and four diversity issues — are further grouped under specific, focused introductions.

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

The identification of the most serious problems reflects not only the mandates of Congress and the IRC, but TAS's integrated approach to advocacy — using individual cases as a means for detecting trends and identifying systemic problems in IRS policy and procedures or the Code. TAS tracks individual taxpayer cases on TAMIS. The top 25 case issues, which are listed in Appendix 1, reflect TAMIS receipts based on taxpayer contacts in fiscal year 2011, a period spanning October 1, 2010, through September 30, 2011.

### **IRS Responses**

TAS provides the IRS's respective operating divisions and functional units with the opportunity to comment on and respond to the problems described in each year's report. For each most serious problem, these responses appear unedited (with the exception of correcting typographical or clerical errors), under the heading "IRS Comments," followed by the National Taxpayer Advocate's own comments and recommendations.

### **Use of Examples**

The examples presented in this report illustrate issues raised in cases handled by TAS. To comply with IRC § 6103, which generally requires the IRS to keep taxpayers' returns and return information confidential, the details of the fact patterns have been changed. In some instances, the taxpayer has provided a written waiver to the National Taxpayer Advocate to use facts specific to that taxpayer's case. These exceptions are noted in footnotes to the examples.

MSP  
#1**The IRS Is Not Adequately Funded to Serve Taxpayers and Collect Taxes****DEFINITION OF 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.

Like any government agency or business, the IRS can improve its effectiveness, and this report contains many recommendations designed to help. Overall, however, the National Taxpayer Advocate believes the IRS has been an effective agency, and 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.<sup>1</sup>

**ANALYSIS OF PROBLEM**

The assigned mission of the IRS is to serve U.S. taxpayers both individually and collectively. From an individual perspective, the IRS should provide taxpayers with the information they need to meet their tax obligations, answer their questions, and provide prompt and effective service when compliance problems arise. From a collective perspective, the IRS generally should collect the correct amount of tax due in order 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.<sup>2</sup> In addition, we note that the role of the IRS has expanded recently from one focused on tax collection to one that also involves distributing benefits to a variety of individuals and businesses.<sup>3</sup>

<sup>1</sup> For a recommendation regarding IRS funding, see National Taxpayer Advocate 2006 Annual Report to Congress 442-457 (Legislative Recommendation: *Revising Congressional Budget Procedures to Improve IRS Funding Decisions*).

<sup>2</sup> We qualify the IRS's duty to collect all tax legally due because there are certain circumstances under which the IRS should not pursue some or all of a tax debt. For example, Congress has made clear that the IRS generally should release a levy that would impose an economic hardship on a taxpayer. See Internal Revenue Code (IRC) § 6343(a)(1)(D).

<sup>3</sup> Among recently enacted benefits are the First-Time Homebuyer Credit, which is intended to encourage home ownership; the American Opportunity tax credit, which is intended to encourage higher education; and the small business tax credit enacted as part of the Patient Protection and Affordable Care Act of 2010, which is intended to encourage certain employers to subsidize health insurance coverage for their workers. The National Taxpayer Advocate has recommended that the IRS revise its mission statement to acknowledge explicitly that its traditional tax-collection mission has expanded to encompass benefits delivery as well. See National Taxpayer Advocate 2010 Annual Report to Congress 15-27 (Most Serious Problem: *The IRS Mission Statement Does Not Reflect the Agency's Increasing Responsibilities for Administering Social Benefits Programs*).

### Background: Sources of IRS Workload Increase

The workload of the IRS has expanded substantially in recent years. Some of the main drivers of the workload increase are as follows:

#### *a. Tax Complexity and the Frequency of Tax-Law Changes.*

In prior reports, the National Taxpayer Advocate has identified the complexity of the tax code as the most serious problem facing taxpayers and the IRS alike.<sup>4</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>5</sup>

For every provision Congress writes, the IRS must write computer code so it can process returns affected by the provision. To identify and stop improper claims, the IRS also must develop filters or other procedures to ensure return accuracy and prevent fraud.

Frequent and late-year tax law changes add to the IRS's workload and increase taxpayer burden. In late 2010, for example, Congress made significant changes that affected itemized deductions. During the 2011 filing season, the IRS therefore could not accept returns from taxpayers who itemized their deductions until February 15 — a full month beyond the start of the filing season.<sup>6</sup>

#### *b. The Service Needs of an Increasingly Diverse Taxpayer Base.*

As discussed later in this report,<sup>7</sup> demographic changes increase the IRS's challenges in conducting outreach and education to taxpayers and in its ability otherwise to meet taxpayer needs.

- Linguistically, about one-fifth of the U.S. population speaks a language other than English at home. This means the IRS must be able to provide service in Spanish and other languages.
- Economically, 15.1 percent of the U.S. population falls below the poverty line. Many of these taxpayers qualify for the Earned Income Tax Credit (EITC) and other benefits requiring substantiation of eligibility, which can create unique obstacles in the tax return process.
- From the perspective of living arrangements, more than five percent of U.S. households consist of unmarried partners. While unmarried partners may share household expenses, the tax law requires them to file separate returns. They therefore must

<sup>4</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>5</sup> See National Taxpayer Advocate 2010 Annual Report to Congress 4.

<sup>6</sup> See IRS News Release, IR-2011-16, *IRS Begins Processing Tax Forms Affected by Late Tax Changes; Taxpayers Can e-File Immediately* (Feb. 15, 2011).

<sup>7</sup> See *Introduction to Diversity Issues: The IRS Should Do More to Accommodate Changing Taxpayer Demographics* and related Most Serious Problems, *infra*.

keep — or create — separate records of their income and expenses for federal income tax purposes.

- From an age perspective, 13 percent of the U.S. population is 65 or older. This population requires information about the complex rules that govern the reporting and taxation of retirement benefits, and many must contend with computing the partial taxation of Social Security benefits.
- Geographically, 79 percent of the population lives in urban areas, while 21 percent lives in rural areas. To cite one example of differing needs, the IRS must have the capacity to provide information about the taxation of farming activities in rural areas, even though farming issues do not arise for the significant majority of the population.

The extraordinary diversity of the taxpaying population means that a one-size-fits-all approach to taxpayer service does not suffice. To maximize public awareness of federal tax requirements and improve tax compliance, the IRS must continually keep up with demographic changes and find new ways to reach and assist all taxpayer segments.

#### *c. A Surge in Tax-Related Identity Theft.*

The IRS reports that it has identified more than 404,000 taxpayers who have been affected by identity theft since 2008.<sup>8</sup> In fiscal year (FY) 2011 alone, the IRS's centralized Identity Protection Specialized Unit (IPSU) received more than 226,000 cases, an increase of 20 percent over FY 2010.<sup>9</sup> Moreover, despite the creation of the IPSU, TAS received more than 34,000 identity theft cases in FY 2011, a 97-percent increase over FY 2010.<sup>10</sup>

In most cases, an identity thief files a return using the Social Security number (SSN) of another individual, either as the primary taxpayer or as the spouse or a dependent claimed on the return. The return claims a refund and requests a debit card, a refund check, or direct deposit into a bank account. A single thief often submits a large number of returns using stolen SSNs early in the filing season. By the time the legitimate taxpayers get around to filing, their returns may be blocked because their SSNs have previously been used for the same tax year.

As we discuss elsewhere in this report,<sup>11</sup> the IRS has made significant progress in improving its procedures to aid victims of identity theft. Identity theft cases have continued to

<sup>8</sup> *Identity Theft and Tax Fraud: Growing Problems for the Internal Revenue Service: Hearing Before the Subcomm. on Government Organization, Efficiency and Financial Management of the H. Comm. on Oversight and Government Reform, 112th Cong. (2011)* (statement of Steven T. Miller, Deputy Commissioner for Services and Enforcement, Internal Revenue Service).

<sup>9</sup> IRS, *IPSU Identity Theft Report* (Oct. 1, 2011); IRS, *IPSU Identity Theft Report* (Oct. 2, 2010); IRS, *IPSU Identity Theft Report* (Oct. 3, 2009). This inventory includes all identity theft cases controlled by the IPSU paper unit, including self-reported non-tax-related identity theft cases, cases the IPSU monitors, and cases undergoing global account review. It does not include 26,695 cases that meet TAS's "systemic burden" case criteria, which the IPSU tracks separately.

<sup>10</sup> In FY 2010, TAS opened 17,291 stolen identity cases (primary issue code (PIC) 425). In FY 2011, the number jumped to 34,006. Taxpayer Advocate Management Information System (TAMIS), FY 2010, FY 2011 (Oct. 31, 2011).

<sup>11</sup> See Most Serious Problem: *Tax-Related Identity Theft Continues to Impose Significant Burdens on Taxpayers and the IRS*, *infra*.

increase, however, and the IRS does not have sufficient procedures or personnel in place to help victims to the extent required. The process of assisting identity theft victims cannot generally be automated. IRS personnel must work directly with victims to understand what has happened, verify that they are the correct taxpayers, and take the actions required to resolve their problems. This work is generally time-consuming.

*d. More Fraudulent Refund Claims.*

The IRS is receiving an increasing number of fraudulent tax returns claiming refunds. Some of this trend overlaps with the identity theft problem described above, but general fraud is more widespread. To protect the fisc, the IRS has been devoting significant enforcement resources to trying to identify and block improper claims. Because filters are inherently imperfect, the IRS must also devote additional taxpayer service resources to assist persons whose refunds are blocked in error.

The increase in questionable claims is attributable to at least two sources. First, the growth in e-filing, while generally positive for taxpayers and the IRS alike, has created more opportunities for criminals to submit multiple returns that report false wages and withholding credits in an attempt to generate refunds. The IRS's Electronic Fraud Detection System (EFDS) is a data-mining program that screens all tax returns claiming refunds to try to identify questionable wages or withholding credits. In calendar year (CY) 2011, EFDS flagged 1,054,704 returns for further review, *an increase of 72 percent over CY 2010*.<sup>12</sup> The IRS has the authority to correct overreporting of withholding credits without conducting examinations and issuing notices of deficiency.<sup>13</sup> These cases are processed by the IRS's Accounts Management Taxpayer Assurance Program (AMTAP).

As noted, however, there is no easy way to distinguish proper claims from improper ones. Filters are, at once, both under-inclusive and over-inclusive, and inevitably block large numbers of proper refund claims. When that happens, the IRS must have sufficient personnel to assist the legitimate taxpayers who are harmed. If, for example, the IRS stops one million refund claims and has a 90-percent accuracy rate, it would need sufficient personnel to quickly work through the claims of 100,000 legitimate taxpayers who were inadvertently caught up in the net.

<sup>12</sup> The number of returns selected to be screened rose from 611,845 in CY 2010 to 1,054,704 in CY 2011. W&I response to TAS information request (July 27, 2011, as updated Nov. 4, 2011). CY 2011 data is only through October 15, but relatively few returns are received after that date.

<sup>13</sup> IRC § 6201(a)(3) authorizes the IRS to assess overstatements of income tax withholding and overstatements of estimated income tax payments in the same manner as in the case of mathematical or clerical errors described in IRC § 6213(b), except that the taxpayer is not given an opportunity to file a request for an abatement of a tax assessment or challenge the assessment in the Tax Court.

As discussed elsewhere in this report,<sup>14</sup> TAS alone received more than 21,000 pre-refund cases in FY 2011, *an increase of 504 percent over FY 2010*.<sup>15</sup> A TAS study found that 75 percent of these taxpayers ultimately were found eligible for the blocked refunds, that the amount of the blocked refunds averaged more than \$5,600, and that the taxpayers had to wait an average of nearly six months to receive them. The IRS must do a better job of assisting these taxpayers quickly.

A second cause of the increase in improper claims is the expansion of spending programs administered through the tax code. As an alternative to direct spending, Congress has enacted a substantial number of refundable tax credits in recent years. Historically, the EITC was the main significant refundable credit,<sup>16</sup> but Congress recently has enacted the First-Time Homebuyer Credit,<sup>17</sup> the Making Work Pay credit,<sup>18</sup> the American Opportunity tax credit,<sup>19</sup> and the health care premium tax credit.<sup>20</sup> It has also made the adoption tax credit fully refundable,<sup>21</sup> and the child tax credit partially refundable.<sup>22</sup>

Refundable credits are often complex and lead to inadvertent error. They also present tempting targets for fraud. Whereas nonrefundable credits, deductions, exclusions, and the like can do no more than reduce a taxpayer's liability to zero, a taxpayer claiming a refundable credit may receive a substantial cash payment.<sup>23</sup>

<sup>14</sup> See Most Serious Problem: *The IRS's Wage and Withholding Verification Procedures May Encroach on Taxpayer Rights and Delay Refund Processing*, *infra*.

<sup>15</sup> TAS, Business Performance Review (4th Quarter FY 2011). The 21,286 pre-refund wage verification cases (PIC 045) actually represent a 571 percent increase over the 3,171 PIC 045 cases received in FY 2010. Because TAS did not use PIC 045 until March 24, 2010, however, a more appropriate comparison is between PIC 045 case receipts from the last two quarters of FY 2011 (18,018 cases) and PIC 045 case receipts from the last two quarters of FY 2010 (2,981 cases), which represents a 504-percent increase. See TAS, Business Performance Review (4th Quarter FY 2010 and 4th Quarter FY 2011).

<sup>16</sup> IRC § 32. The EITC is effectively a wage supplement for low income workers.

<sup>17</sup> IRC § 36. The First-Time Homebuyer Credit, as modified, most recently provided up to \$8,000 to certain first-time or long-time homeowners for qualifying 2010 purchases.

<sup>18</sup> IRC § 36A. The Making Work Pay credit expired on Dec. 31, 2010.

<sup>19</sup> IRC § 25A(i). The American Opportunity tax credit is partially refundable and may be used to offset the costs of college tuition, fees, and course materials. See IRC § 25A(i)(6).

<sup>20</sup> IRC § 36B. The health care premium tax credit is designed to help low income individuals purchase coverage under a qualified health plan beginning in 2014.

<sup>21</sup> IRC § 36C. The adoption credit, which offsets the costs of adoptions, is scheduled to become non-refundable after tax year (TY) 2012 unless Congress extends its refundable status.

<sup>22</sup> IRC § 24(d). The refundable portion is known as the Additional Child Tax Credit, and eligibility is dependent on earnings.

<sup>23</sup> Despite the risk of fraud, the National Taxpayer Advocate has repeatedly noted that refundable credits may also be an effective means of delivering benefits to target populations. In prior reports, we have recommended certain criteria for Congress to consider when deciding whether the advantages of administering particular benefits through the tax code outweigh the disadvantages. See National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 75-104 (Analysis: *Running Social Programs Through the Tax System*); see also National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 101-119 (Analysis: *Evaluate the Administration of Tax Expenditures*). We have also emphasized that the IRS should not overreact to the publicity about refund fraud by pulling significant resources from its other audit programs. IRS National Research Program (NRP) data for tax year (TY) 2001 suggest that approximately 55 percent (\$109 billion) of the individual underreporting gap (totaling approximately \$197 billion) came from understated net business income, such as unreported receipts and overstated expenses for self-employed taxpayers. By contrast, only about nine percent (\$17 billion) came from overstated tax credits. Yet the IRS audits individual taxpayers claiming the EITC at more than twice the rate of other taxpayers and EITC audits constitute about one-third of all IRS examinations, even though EITC audits on average yield only about one-third as much tax as other audits. See IRS Pub. 55-B, IRS Data Books (2006-2010), Table 9a; EITC Program Office response to TAS information request (May 18, 2011).

Distinguishing between valid claims, overclaims attributable to error, and overclaims attributable to fraud is resource-intensive. Moreover, the IRS generally may not reject claims for tax credits using math error authority. It typically must issue a notice of deficiency when it believes a claim is improper, and doing so generally involves an audit (although as we discuss elsewhere in this report, the IRS is experimenting with procedures that undermine this important taxpayer protection).<sup>24</sup> In attempting to address the suspected surge in questionable refundable credit claims, the Examination function has been stretched thin. Since FY 2009, for example, Examination has closed about 526,000 audits of First-Time Homebuyer Credit claims, including some 303,000 in FY 2010 alone.<sup>25</sup> The total number of non-EITC correspondence audits closed in FY 2010 was 686,796, which means that 43 percent of the non-EITC correspondence examinations closed in that year pertained to the First-Time Homebuyer Credit.<sup>26</sup> That was new work that limited the IRS's capacity to audit other high-risk returns and may have diverted resources from other programs.

*e. Implementation of New Third-Party Information Reporting Requirements.*

Congress has enacted several new third-party information reporting requirements in recent years. Most notably, credit card issuers generally will be required to report the aggregate amount of reportable payments they process for businesses,<sup>27</sup> and brokerage firms generally will be required to report the cost basis (as well as gross proceeds) of stock, bond, and mutual fund sales.<sup>28</sup> The purpose of these requirements is to improve tax compliance, but the provisions are not self-executing. The IRS has been devoting significant resources to build systems that are capable of comparing the data received from third parties against information reported on tax returns to identify inconsistencies. The new reporting regime remains a work in progress, and the IRS will be required to continue to devote resources to refine the system and make sure it is able to utilize the data it receives productively.

It is important to emphasize that document-matching programs, and the automated anti-fraud programs discussed above, simply identify data discrepancies. In many cases, the taxpayer's return position turns out to be the correct one. Therefore, the use or expansion of any automated compliance program generates additional downstream work when taxpayers write or call to dispute a proposed adjustment or simply to inquire about it. If the IRS does not have the resources to assist taxpayers who respond properly, it cannot implement or expand the use of such a program without adverse taxpayer impact.<sup>29</sup>

<sup>24</sup> See Most Serious Problem: *The IRS's Wage and Withholding Verification Procedures May Encroach on Taxpayer Rights and Delay Refund Processing*, *infra*; Most Serious Problem: *Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights*, *infra*; *An Analysis of the IRS Examination Strategy: Proposals to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*, *infra*.

<sup>25</sup> IRS, First-Time Homebuyer Credit Enforcement Report FY 2009 – FY 2012 (Dec. 2011). Since FY 2009, just over 4.3 million First-Time Homebuyer Credit claims have been filed.

<sup>26</sup> See IRS Pub. 55-B, Data Book (2010), Table 9a.

<sup>27</sup> IRC § 6050W.

<sup>28</sup> IRC § 6045(g).

<sup>29</sup> For an example of the consequences of inadequate staffing in an enforcement program, see 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*, *infra*.

### Effect of Inadequate Resources on Taxpayer Services

While the IRS has experienced a significant increase in its workload, it has not received a corresponding increase in its resources. To the contrary, the IRS's budget was reduced slightly from FY 2010 to FY 2011,<sup>30</sup> and has been cut by an additional 2.5 percent for FY 2012.<sup>31</sup> These reductions are affecting the IRS's operations generally, and are particularly likely to impact taxpayer service.

Two key indicators of taxpayer service are the IRS's ability to answer taxpayer telephone calls and the IRS's ability to respond to taxpayer correspondence. From FY 2004 to FY 2011, the percentage of calls the IRS was able to answer from taxpayers seeking to speak with a telephone assistor dropped from 87 percent to 70 percent.<sup>32</sup>

Over the same period, the IRS's ability to timely process taxpayer correspondence also declined. Comparing the final week of FY 2004 with the final week of FY 2011, the backlog of taxpayer correspondence in the tax adjustments inventory jumped by 158 percent (from 357,151 to 920,768), and the percentage of taxpayer correspondence in this inventory classified as "over-age" increased by 309 percent (from 11.5 percent to 47.0 percent of correspondence).<sup>33</sup> Correspondence generally is considered over-age when it is 45 days old or older and the issue it addresses has not been resolved.<sup>34</sup>

The decline in these key measures is deeply disturbing. Telephone calls and correspondence are the two main ways taxpayers communicate with the IRS. Few government agencies or businesses would be satisfied if their customer service departments were unable to answer three out of every ten calls, nor would they be content if nearly half of all correspondence took more than 6-1/2 weeks to answer.

Taxpayer service levels may decline further if additional budget reductions are enacted. In a recent letter to the chairmen and ranking members of key committees of the Congress, the Commissioner of Internal Revenue warned:

[C]uts of the magnitude contemplated in the current appropriations bills (approximately \$525 million from core IRS accounts in the Senate bill and \$650 million in the House bill) would lead to noticeable degradation of both service and enforcement and would have a serious detrimental impact on voluntary compliance for years to come. . . .

<sup>30</sup> Department of Defense and Full-Year Continuing Appropriations Act, 2011, Pub. L. No. 112-10, § 1119, 1125 Stat. 38, 107 (2011).

<sup>31</sup> H.R. 2055, Consolidated Appropriations Act, 2012, Division C, Title I (112th Cong.).

<sup>32</sup> Compare IRS, Joint Operations Center, *Snapshot Reports: Customer Account Services - CAS* (week ending Sept. 30, 2011) with IRS, Joint Operations Center, *Snapshot Reports: Customer Account Services - CAS* (week ending Sept. 30, 2004). These percentages reflect the number of calls that reached telephone assisters among all calls seeking to do so.

<sup>33</sup> Compare IRS, Joint Operations Center, *Weekly Enterprise Adjustments Inventory Report* (week ending Oct. 1, 2011) with IRS, Joint Operations Center, *Weekly Enterprise Adjustments Inventory Report* (week ending Sept. 25, 2004).

<sup>34</sup> W&I FY 2012 Account Management Program Letter and Operating Guidelines (Dec. 12, 2011). In some instances, the definition of over-age varies based on factors such as the type of work, the program, the site, and inventory levels. TAS conversation with Joint Operations Center Paper Inventory Analyst (Dec. 13, 2011).

Responses to taxpayers' letters (including taxpayers who have received a notice and are trying to resolve account issues) would be delayed up to 5 months. Approximately half of the nation's taxpayers attempting to call the IRS would either be unable to get through or hang up in frustration.<sup>35</sup>

The Chairman of the IRS Oversight Board expressed similar concerns in a letter to the chairmen and ranking members of House and Senate Appropriations Committees. He also stated:

The private sector experience of the Board members reinforces our belief that taxpayers who contact the IRS seeking assistance deserve service, and when taxpayers experience delays in obtaining service, the results are dysfunctional. For example, taxpayers may make costly mistakes, put themselves in jeopardy of enforcement action by the IRS, and in the long term, lose confidence in the tax system.<sup>36</sup>

The Internal Revenue Service Advisory Council (IRSAC), a federal advisory committee composed of members of the public, has also sounded alarm bells. In a section of its recently released 2011 annual report titled "The IRS Must Receive Consistent, Adequate and Appropriate Funding to Achieve the Proper Administrative Balance Between Service, Compliance and Tax Enforcement," the IRSAC wrote:

Limited resources are forcing the IRS to continually streamline its services. An example of this approach is the limited ability of taxpayers to interface with a local IRS representative when responding to a notice, when seeking resolution of an issue, or during the process of tax collection or the processing of offers in compromise. Instead, taxpayers and representatives often encounter numerous erroneous notices and lengthy holding periods on the telephone followed by a non-discretionary approach that sometimes fails to comprehend the unique issues involved. Every taxpayer is not alike and the need for face-to-face interaction should not be overlooked or ignored in favor of budgetary concerns. . . .

Congress should appropriately fund the IRS to assure continued success in service, compliance, and enforcement. Without adequate funding, both taxpayers and the tax system will continue to suffer.<sup>37</sup>

<sup>35</sup> Letter from Douglas H. Shulman, Commissioner of Internal Revenue, to the Chairs and Ranking Members of the House and Senate Appropriations Subcommittees on Financial Services and General Government, the House Committee on Ways and Means and its Subcommittee on Oversight, and the Senate Committee on Finance (Oct. 17, 2011).

<sup>36</sup> Letter from Paul Cherecwich, Jr., Chairman of the IRS Oversight Board, to the Chairs and Ranking Members of the House and Senate Committees on Appropriations (Oct. 20, 2011).

<sup>37</sup> Internal Revenue Service Advisory Council, 2011 General Report (Nov. 16, 2011).

The National Taxpayer Advocate shares the concerns expressed by the Commissioner, the Oversight Board, and the IRSAC.<sup>38</sup>

### Effect of Inadequate Resources on Tax Compliance

As of this writing, the most recent comprehensive data the IRS has released on noncompliance pertains to tax year (TY) 2001.<sup>39</sup> The IRS estimated the amount of tax not timely paid for TY 2001 was \$345 billion, or 16 percent of tax due.<sup>40</sup> The IRS estimated that it collected about \$55 billion through late payments and enforcement action, leaving a “net” tax gap of \$290 billion. However, the IRS has acknowledged that the actual tax gap is probably larger. For example, the study did not even venture a guess as to the amount of illegal-source income that goes unreported and on which taxes are not paid.

It will never be possible to eliminate the tax gap entirely, of course, but even modest improvements would help to reduce the federal budget deficit. Moreover, even apart from the fiscal implications, the size of the tax gap raises important equity concerns. Compliant taxpayers pay a great deal of money each year to subsidize noncompliance by others. Dividing the estimated 2001 net tax gap of \$290 billion by the estimated 108,209,000 households that existed in the United States in that year<sup>41</sup> suggests that the average household was assessed a “surtax” of about \$2,680 to enable the federal government to raise the same level of revenue it would have collected if all taxpayers had reported their income and paid their taxes in full. That is not a burden we should expect our nation’s taxpayers to bear lightly.<sup>42</sup>

<sup>38</sup> For additional discussion of these concerns, see the following Most Serious Problems discussed in this report: *Tax-Related Identity Theft Continues to Impose Significant Burdens on Taxpayers and the IRS*; *The IRS Does Not Emphasize the Importance of Personal Taxpayer Contact as an Effective Tax Collection Tool*; *The IRS Procedures for Replacing Stolen Direct Deposit Refunds Are Not Adequate*; *The IRS’s Failure to Consistently Vet and Disclose Its Procedures Harms Taxpayers, Deprives It of Valuable Comments, and Violates the Law*; *After Refund Anticipation Loans: Taxpayers Require Improved Education About Refund Delivery Options and the Availability of a Government-Sponsored Debit Card*; *The IRS Should Reevaluate Earned Income Tax Credit Compliance Measures and Take Steps to Improve Both Service and Compliance*; *Accelerated Third Party Information Reporting and Pre-Populated Returns 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*; *Reinstatement of a Modernized Telefile Would Reduce Taxpayer Burden and Benefit Tax Administration*; *The New Income Filter for the Federal Payment Levy Program Does Not Fully Protect Low Income Taxpayers from Levies on Social Security Benefits*; *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*; *Introduction: Compliance Challenges Increase International Taxpayers’ Need for IRS Services and May Undermine the Effectiveness of IRS Enforcement Initiatives in the International Arena*; *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*; *Small Businesses Involved in International Economic Activity Need Targeted IRS Assistance*; *Individual U.S. Taxpayers Working, Living, or Doing Business Abroad Require Expanded Service Targeting Their Specific Needs and Preferences*; *Globalization Requires Greater Internal IRS Coordination of International Taxpayer Service*; *Foreign Taxpayers Face Challenges in Fulfilling U.S. Tax Obligations*; *The IRS Makes Reinstatement of an Organization’s Exempt Status Following Automatic Revocation Unnecessarily Burdensome*; *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*; *The IRS Has Significantly Improved the Accuracy of Restricted Interest Computations, but Problems with Failure-to-Pay Penalty Computations Continue to Cause Interest Errors, infra.*

<sup>39</sup> The IRS is expected to release an updated estimate of the tax gap in the near future.

<sup>40</sup> See IRS, *Tax Gap Map for Tax Year 2001* (Feb. 2007), available at [http://www.irs.gov/pub/irs-utl/tax\\_gap\\_update\\_070212.pdf](http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf).

<sup>41</sup> U.S. Census Bureau, Population Division (data as of Mar. 2001).

<sup>42</sup> Significantly, the IRS Oversight Board reports there is substantial public support for an enhanced IRS compliance program, provided that it is balanced. The Oversight Board conducts an annual survey of taxpayer attitudes which consistently finds that a substantial majority of taxpayers supports additional funding for both IRS assistance and enforcement. See, e.g., IRS Oversight Board, *2010 Taxpayer Attitude Survey* 15 (Jan. 2011).

As the statutorily designated advocate for taxpayers collectively as well as for taxpayers with specific account problems, the National Taxpayer Advocate is concerned about the economic and social costs that this noncompliance imposes. Since our 2003 Annual Report to Congress, we have frequently raised concerns about the tax gap and offered balanced proposals designed to reduce it.<sup>43</sup>

### IRS Funding Principles

The National Taxpayer Advocate has previously expressed the view that the IRS, as the nation's tax collector, should generally be exempt from any budget freeze or reduction.<sup>44</sup> We hold this view for two reasons. First, 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. While few people enjoy paying taxes, 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 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.

<sup>43</sup> See National Taxpayer Advocate 2010 Annual Report to Congress 373-376 (Legislative Recommendation: *Repeal Information Reporting on Purchases of Goods but Require Reporting on Corporate and Certain Other Payments*); National Taxpayer Advocate 2009 Annual Report to Congress 155-157 (Introduction to Examination Issues: *The IRS Examination Strategy Fails to Maximize Voluntary Compliance*); National Taxpayer Advocate 2009 Annual Report to Congress 158-167 (Most Serious Problem: *The IRS Correspondence Examination Program Does Not Maximize Voluntary Compliance*); National Taxpayer Advocate 2009 Annual Report to Congress 168-173 (Most Serious Problem: *The IRS Examination Function Is Missing Opportunities to Maximize Voluntary Compliance at the Local Level*); National Taxpayer Advocate 2009 Annual Report to Congress 174-179 (Most Serious Problem: *The IRS Does Not Know If It Is Using State and Local Data Effectively to Maximize Voluntary Compliance*); National Taxpayer Advocate 2009 Annual Report to Congress 180-184 (Most Serious Problem: *The IRS Lacks a Comprehensive "Income" Database that Could Help Identify Underreporting and Improve Audit Efficiency*); National Taxpayer Advocate 2009 Annual Report to Congress 185-190 (Most Serious Problem: *The IRS Does Not Have a Significant Audit Program Focused on Detecting the Omission of Gross Receipts*); National Taxpayer Advocate 2009 Annual Report to Congress 191-195 (Most Serious Problem: *The IRS Has Delayed Minor Tax Form Changes that Would Promote Voluntary Compliance and Increase Audit Efficiency*); National Taxpayer Advocate 2008 Annual Report to Congress 54-78 (Most Serious Problem: *Employment Taxes*); National Taxpayer Advocate 2007 Annual Report to Congress 213-226 (Most Serious Problem: *The IRS Should Proactively Address Emerging Issues Such as Those Arising from "Virtual Worlds"*); National Taxpayer Advocate 2007 Annual Report to Congress 35-65 (Most Serious Problem: *The Cash Economy*); National Taxpayer Advocate 2007 Annual Report to Congress 242-258 (Most Serious Problem: *Nonfiler Program*); National Taxpayer Advocate 2007 Annual Report to Congress 303-323 (Most Serious Problem: *Audits of S Corporations*); National Taxpayer Advocate 2007 Annual Report to Congress 490-502 (Legislative Recommendation: *Measures to Address Noncompliance in the Cash Economy*); National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 1-43 (*A Comprehensive Strategy for Addressing the Cash Economy*); National Taxpayer Advocate 2006 Annual Report to Congress 6-9 (Most Serious Problem: *The Tax Gap*); National Taxpayer Advocate 2005 Annual Report to Congress 55-75 (Most Serious Problem: *The Cash Economy*); National Taxpayer Advocate 2005 Annual Report to Congress 238-248 (Most Serious Problem: *Limited Scope of Backup Withholding Program*); National Taxpayer Advocate 2005 Annual Report to Congress 381-396 (Legislative Recommendation: *Measures to Reduce Noncompliance in the Cash Economy*); National Taxpayer Advocate 2004 Annual Report to Congress 211-225 (Most Serious Problem: *IRS Examination Strategy*); National Taxpayer Advocate 2004 Annual Report to Congress 226-245 (Most Serious Problem: *IRS Collection Strategy*); National Taxpayer Advocate 2004 Annual Report to Congress 246-263 (Most Serious Problem: *Federal Contractors and the Federal Payment Levy Program*); National Taxpayer Advocate 2004 Annual Report to Congress 478-489 (Legislative Recommendation: *Tax Gap Recommendations*); National Taxpayer Advocate 2003 Annual Report to Congress 20-25 (Most Serious Problem: *Nonfiling and Underreporting by Self-Employed Taxpayers*); National Taxpayer Advocate 2003 Annual Report to Congress 256-269 (Legislative Recommendation: *Tax Withholding on Non-Wage Workers*) (containing proposals that the National Taxpayer Advocate has since modified).

<sup>44</sup> See *Hearing on FY 2012 IRS Budget: Hearing Before the Subcomm. on Financial Services and General Government of the S. Comm. on Appropriations, 112th Congress (2011)* (statement of Nina E. Olson, National Taxpayer Advocate); see also National Taxpayer Advocate 2006 Annual Report to Congress 442-457 (Legislative Recommendation: *Revising Congressional Budget Procedures to Improve IRS Funding Decisions*).

Second, more funding for the IRS means more federal revenue. 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 virtually all other federal spending possible.<sup>45</sup> On a budget of about \$12.1 billion,<sup>46</sup> the IRS collected about \$2.42 trillion in FY2011.<sup>47</sup> In other words, for every \$1 that Congress appropriated for the IRS, the IRS collected about \$200 in return.<sup>48</sup> Policymakers may disagree fervently about the appropriate level of taxation, but there is little disagreement that the IRS should enforce the law fairly and consistently.

Rather than recognizing the IRS's unique role as the revenue engine for the federal government, however, the congressional budget rules treat spending for the IRS exactly the same way they treat spending for all other federal agencies — a dollar spent is simply a dollar spent, with no consideration given to how many dollars the IRS will raise in return.<sup>49</sup>

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 collect substantially more revenue.<sup>50</sup>

Former IRS Commissioner Charles Rossotti has written:

When I talked to business friends about my job at the IRS, they were always surprised when I said that the most intractable part of the job, by far, was dealing with

<sup>45</sup> See IRS Fact Sheet, FS-2011-09, *IRS FY 2012 Budget Proposal Summary* (Feb. 2011), available at <http://www.irs.gov/newsroom/article/0,,id=235959,00.html>.

<sup>46</sup> Department of the Treasury, *FY 2012 Budget in Brief* (showing FY 2010 enacted levels); Department of Defense and Full-Year Continuing Appropriations Act, 2011, Pub. L. No. 112-10, § 1119, 1125 Stat. 38, 107 (2011) (making 0.2 percent reduction in FY 2010 enacted levels for FY 2011).

<sup>47</sup> Government Accountability Office, GAO-12-165, *Financial Audit: IRS's Fiscal Years 2011 and 2010 Financial Statements* at 63 (Nov. 2011).

<sup>48</sup> In evaluating the likely revenue benefits of additional funding, the average return on investment (ROI) of 200:1 is less important than the marginal ROI that can be achieved for each additional dollar spent. While the marginal ROI is considerably less than 200:1 and will differ by program, studies generally show that, within reasonable limits, each additional dollar appropriated to the IRS generates substantially more than an additional dollar in federal revenue, assuming the funding is wisely spent.

<sup>49</sup> There is one exception to this rule. Under a mechanism known as a “program integrity allocation adjustment,” new funding appropriated for IRS enforcement programs may not count against otherwise applicable spending ceilings provided (1) the IRS's existing enforcement base is fully funded and (2) a determination is made that the proposed additional expenditures will generate an ROI of greater than 1:1 (i.e., the additional expenditures will reduce the deficit on a net basis). However, this mechanism has been used only a few times and only for enforcement programs, despite widespread acknowledgment that taxpayer service activities also contribute to tax compliance.

<sup>50</sup> The exact “multiplier” effect varies by program and is hard to measure with precision. Commissioner Shulman recently wrote that “cutting the IRS budget by the contemplated levels would mean that front-line IRS staffing levels must be substantially reduced, leading to a measureable decrease of approximately \$4 billion in revenue annually, or seven times the reduction in [the] budget.” Letter from Douglas H. Shulman, Commissioner of Internal Revenue, to the Chairs and Ranking Members of the House and Senate Appropriations Subcommittees on Financial Services and General Government, the House Committee on Ways and Means and its Subcommittee on Oversight, and the Senate Committee on Finance (Oct. 17, 2011).

the IRS budget. The reaction was usually “Why should that be a problem? If you need a little money to bring in a lot of money, why wouldn’t you be able to get it?”<sup>51</sup>

Yet obtaining a little extra money to bring in a lot of extra money remains an intractable challenge for the IRS, and that is unfortunate. Without additional resources, the IRS will be unable to provide timely and effective taxpayer service and will be unable to make much, if any, progress in reducing the tax gap.

## CONCLUSION

The IRS does not have enough resources to handle its current workload. The lack of adequate funding for the IRS causes multiple problems. Taxpayers calling the IRS with tax-law questions often cannot get through, creating considerable frustration and potentially reducing compliance. Compliant taxpayers whose refunds are held up or who are audited do not receive timely responses to their phone calls and correspondence. The IRS lacks the resources to maximize revenue collection, thereby exacerbating the federal budget deficit. And compliant taxpayers who see that the IRS is not able to pursue noncompliant taxpayers adequately begin to feel like “tax chumps,” potentially making them less likely to comply in the future, particularly in the case of small business taxpayers for whom paying taxes may place them at a competitive disadvantage.

## 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 enable the IRS to meet taxpayer needs and 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, the National Taxpayer Advocate recommends that Congress consider exempting the IRS from spending ceilings or even taking the IRS off-budget.

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<sup>51</sup> Charles O. Rossotti, *Many Unhappy Returns: One Man’s Quest to Turn Around the Most Unpopular Organization in America* 278 (2005). On pages 278-286, Mr. Rossotti presents an interesting personal perspective on the budget process and the politics behind the chronic under-funding of the IRS.

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

## 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

### OVERVIEW

Historically, when a taxpayer filed a return and signed it under penalties of perjury, the IRS assumed it was correct.<sup>1</sup> Except in the case of clear mathematical errors (and inconsistencies evident on the face of the return), the IRS generally did not disturb the taxpayer's self-assessed liability unless it examined the return and identified a problem.<sup>2</sup> Perhaps assuming the IRS would assess most deficiencies only after an examination, Congress granted taxpayers procedural rights in connection with that process. Thus, when conducting an examination, the IRS was required to follow legally-mandated procedures (described below) designed to minimize burden, inform taxpayers of their rights, and ensure the determination was correct. It provided taxpayers an opportunity to appeal the determination to the IRS Office of Appeals and the United States Tax Court before paying the disputed assessment. These procedures promoted accuracy and established important taxpayer rights.

Today, when a taxpayer's return is inconsistent with information the IRS receives 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 over 15 million contacts that taxpayers might regard as examinations, but treated only about ten percent (1.6 million) as “real” examinations, subject to real examination procedures and taxpayer protections<sup>3</sup> — and it conducted about 78 percent of the “real” examinations by correspondence in a highly-automated campus setting where it is more challenging for the taxpayer to communicate with the examiner.<sup>4</sup>

It is easy to understand why the IRS has embraced an automated approach. Without automation, it would be more difficult to prevent improper payments while also timely

<sup>1</sup> For an interesting analysis of the tax assessment process and the recent rise of automation, see Bryan T. Camp, *Theory and Practice in Tax Administration*, 29 Va. Tax Rev. 227 (Fall 2009). For a broader discussion of automation, see *From Tax Collector to Fiscal Automaton: Demographic History of Federal Income Tax Administration, 1913-2011*, vol 2, *infra*.

<sup>2</sup> The IRS was able to identify returns that did not match third-party information reporting (e.g., Forms W-2 and 1099) in the 1960s and 1970s. Bryan T. Camp, *Theory and Practice in Tax Administration*, 29 Va. Tax Rev. 227 (Fall 2009). It was not until 1990, however, when the IRS's Automated Underreporter (AUR) system went online, that IRS computers could identify each mismatch and attempt to fix it by automatically generating letters to taxpayers. *Id.*

<sup>3</sup> The IRS conducted 1,581,394 examinations of individuals, closed 4,336,000 AUR contact cases, sent 8,445,374 million math error notices, and made 1,175,000 Automated Substitute for Return (ASFR) contacts in FY 2010. IRS Pub. 55B, Data Book, *Table 14, Information Reporting Program (FY 2010)* (math error, AUR, and ASFR data); IRS Pub. 55B, Data Book, *Table 9a, Examination Coverage (2010)* (examination data).

<sup>4</sup> IRS Pub. 55B, Data Book, *Table 9a, Examination Coverage (2010)* (reflecting 1,581,394 examinations of individuals in FY 2010, including 1,238,632 by correspondence from an IRS campus and 342,762 in the field or from a field office). For further discussion of this problem, see *An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*, vol. 2 *infra*.

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delivering tax benefits.<sup>5</sup> The recent increase in spending programs run through the tax code,<sup>6</sup> combined with a reduction in IRS funding, makes the IRS's job even more challenging, as described in the most serious problem (MSP) entitled "*The IRS Is Not Adequately Funded To Serve Taxpayers and Collect Taxes.*" Reports of identity thieves and others making improper claims for refunds also increase the pressure upon the IRS to use automation to address the problem.<sup>7</sup> In addition, when enacting new tax benefits, Congress sometimes expands the IRS's "math error" authority to make automated assessments with respect to the new benefits, as it did with the Making Work Pay (MWP) credit and the First-Time Homebuyer Credit (FTHBC).<sup>8</sup>

Automating certain compliance checks makes sense.<sup>9</sup> However, automated adjustments are often less accurate than face-to-face examinations, particularly when the third-party data is unreliable or either the IRS or the taxpayer has difficulty communicating.<sup>10</sup> In addition, automated procedures may sidestep taxpayer protections applicable to "real" examinations. Without sufficient safeguards, automated procedures are more likely to eliminate or delay tax benefits properly due and desperately needed by some. Thus, as the IRS increases its reliance on automation to "protect revenue," it should appropriately balance these efforts by simultaneously increasing its efforts to protect taxpayers who are sincerely trying to

<sup>5</sup> The National Taxpayer Advocate has recommended that the IRS expressly recognize its dual mission. See National Taxpayer Advocate 2010 Annual Report to Congress 15 (Most Serious Problem: *The IRS Mission Statement Does Not Reflect the Agency's Increasing Responsibilities for Administering Social Benefits Programs*).

<sup>6</sup> For a more in-depth discussion, see National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, at 101-119 (Research Study: *Evaluate the Administration of Tax Expenditures*) and National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, at 75-104 (Research Study: *Running Social Programs Through the Tax System*).

<sup>7</sup> See, e.g., Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2009-30-141, *Improvements Are Needed in the Administration of Education Credits and Reporting Requirements for Educational Institutions* (Sept. 2009); TIGTA, Ref. No. 2009-40-057, *Actions Are Needed to Ensure Proper Use of Individual Taxpayer Identification Numbers and to Verify or Limit Refundable Credit Claims* (Mar. 31, 2009); TIGTA, Ref. No. 2010-41-011, *Evaluation of the Internal Revenue Service's Capability to Ensure Proper Use of Recovery Act Funds* (Nov. 27, 2009); TIGTA, Ref. No. 2009-40-142, *The 2009 Filing Season Was Successful Despite Significant Challenges Presented by the Passage of New Tax Legislation* (Sept. 21, 2009); Government Accountability Office (GAO), GAO-11-691T, *Enhanced Prerefund Compliance Checks Could Yield Significant Benefits* (May 25, 2011); *Improper Payments in the Administration of Refundable Tax Credits, Hearing Before the H. Subcomm. on Oversight, Comm. on Ways and Means* (May 25, 2011). For additional discussion, see Most Serious Problem: *The IRS's Wage and Withholding Verification Procedures May Encroach on Taxpayer Rights and Delay Refund Processing and Tax-Related Identity Theft Continues to Impose Significant Burdens on Taxpayers and the IRS, infra*.

<sup>8</sup> See, e.g., IRC § 6213(g)(2)(N) (MWP); IRC § 6213(g)(2)(O) and (P) (FTHBC). For additional discussion of math error, see Most Serious Problem: *Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights, infra*.

<sup>9</sup> For example, it might make sense to extend math error authority to address improper claims for the American Opportunity Tax Credit (IRC § 25A(i)). See *Complexity and the Tax Gap: Making Tax Compliance Easier and Collecting What's Due, Hearing Before the Senate Comm. on Finance* (June 28, 2011) (statement of Nina E. Olson, National Taxpayer Advocate); *Improper Payments in the Administration of Refundable Tax Credits, Hearing Before the H. Subcomm. on Oversight, Comm. on Ways and Means* (May 25, 2011). Because the credit is available only for the first four years of a student's post-secondary education, and because the number of years claimed for each student is apparent on the face of the return, additional math error authority would enable the IRS to stop the improper payment of capped claims with minimal resources. *Id.*

<sup>10</sup> According to the IRS, when it conducts Earned Income Tax Credit (EITC) examinations face-to-face, as it does in connection with the National Research Program (NRP), it achieves an 85 percent response rate (for FY 2007), but this figure falls to 30 percent (for FY 2010) for regular EITC examinations conducted by correspondence. Most Serious Problem: *The IRS Needs to Reevaluate Earned Income Tax Credit Measures and Take Steps to Improve Both Service and Compliance, infra* (IRS comments). Moreover, the IRS assumes for purposes of the NRP that many who do not respond are, in fact, entitled to the EITC they claimed. *Id.*

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comply as well as protecting longstanding taxpayer rights. As described in the MSPs that follow, the IRS's approach will be balanced only if:

- The IRS's automated systems use only the most reliable data;
- The IRS's letters reach taxpayers and clearly explain the discrepancy at issue along with any applicable procedures and taxpayer rights; and
- The IRS's mitigation procedures make it easy for taxpayers to communicate with the IRS to explain apparent discrepancies and resolve problems.

## DISCUSSION

### The IRS could use automation to help taxpayers and increase compliance.

Although automation has the potential to harm taxpayers who are trying to comply, it can be helpful. The IRS has long-term plans to make third-party data electronically available to taxpayers before they file.<sup>11</sup> By making it available for download or as part of a simple pre-populated return, the IRS could increase compliance and reduce the stress associated with tax preparation. Such assistance could be particularly helpful to low income taxpayers who file a return just to claim benefits, such as the earned income tax credit (EITC).<sup>12</sup> To date, however, the IRS has focused instead on using third-party data for post-filing enforcement, particularly with respect to refundable credits.

### The IRS is charged with administering an increasing number of refundable tax credits.

The IRS administers a wide range of refundable tax credits.<sup>13</sup> In addition to credits such as the EITC, the Additional Child Tax Credit, and the fuel tax credit,<sup>14</sup> which have long been refundable, Congress recently made some other longstanding credits refundable, including the Hope Scholarship Credit for educational expenses, and the Adoption Tax Credit.<sup>15</sup> It has also recently added new refundable credits such as the First-Time Homebuyer Credit

<sup>11</sup> See IR-2011-38, *Prepared Remarks of IRS Commissioner Doug Shulman at the National Press Club* (Apr. 6, 2011); IR-2011-114, *IRS to Host Public Meeting Dec. 8 on Real-Time Tax System* (Nov. 30, 2011). The National Taxpayer Advocate is pleased that the IRS has embraced her vision in this regard. For a discussion of the National Taxpayer Advocate's vision, see National Taxpayer Advocate 2009 Annual Report to Congress 338 (Legislative Recommendation: *Direct the Treasury Department to Develop a Plan to Reverse the "Pay Refund First, Verify Eligibility Later" Approach to Tax Return Processing*).

<sup>12</sup> For further discussion of this issue, see Most Serious Problem, *Accelerated Third-Party Information Reporting and Pre-Populated Returns Would Reduce Taxpayer Burden and Benefit Tax Administration*, *infra*.

<sup>13</sup> For additional discussion of these credits, see, e.g., Most Serious Problem: *The IRS Is Not Adequately Funded to Serve Taxpayers and Collect Taxes*, *infra*; and Most Serious Problem: *The IRS's Wage and Withholding Verification Procedures May Encroach on Taxpayer Rights and Delay Refund Processing*, *infra*.

<sup>14</sup> IRC § 32 (EITC); IRC § 24(d) (Additional Child Tax Credit); IRC § 34 (fuel tax credit). The Additional Child Care Tax Credit (ACTC) became refundable in 2001. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 201(c), 115 Stat. 38, 46 (2001). The Patient Protection and Affordable Care Act of 2010 (PPACA) increased the ACTC, effective for tax years beginning after December 31, 2009. Pub. L. No. 111-148, § 10909(b), 124 Stat. 119, 1022 (2010).

<sup>15</sup> The PPACA replaced the adoption credit under former IRC § 23 with a refundable adoption credit under IRC § 36C, effective for tax years beginning after December 31, 2009. Pub. L. No. 111-148, § 10909(b), 124 Stat. 119, 1023 (2010). The American Recovery and Reinvestment Act of 2009 created the American Opportunity Tax Credit (AOTC), an expansion of the Hope Scholarship Credit, making it partially refundable, effective for 2009 and 2010. Pub. L. No. 111-5, § 1004, 123 Stat. 115, 313 (2009) (codified at IRC § 25A(i)). The AOTC was further extended to the 2011 and 2012 tax years by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. Pub. L. No. 111-312, § 103(a)(1), 124 Stat. 3296, 3299 (2010).

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for the purchase of a home, the Making Work Pay credit, and the credit for qualified health insurance premiums.<sup>16</sup>

### Reports of identity theft and improper claims for credits increase pressure on the IRS to use automation to “protect revenue.”

When administering refundable credits, the IRS becomes a target for identity thieves, organized crime, and others seeking improper payments. Organizations charged with overseeing the IRS have urged the IRS to use automation to prevent or recover payments on improper claims.<sup>17</sup> The IRS Accounts Management Taxpayer Assurance Program (AMTAP) recently established the Automated Questionable Refund (AQR) pilot to expand its use of automation to prevent improper refunds.

### The IRS continues to expand its use of automation in lieu of face-to-face examinations in many areas.

As described in the MSPs that follow, the IRS has significantly increased its use of automated procedures for second-guessing returns (or the taxpayer’s decision not to file) in a wide range of areas.

- The Electronic Fraud Detection System (EFDS) selected 1,054,704 returns in calendar year (CY) 2011 — an increase of 72 percent over the prior year;<sup>18</sup>
- The math error program processed 10.6 million math errors and issued 8.4 million math error notices in FY 2010 — 170 percent more than in FY 2003;<sup>19</sup>
- The Automated Underreporter (AUR) matching program closed 4,336,000 cases in FY 2010 — 277 percent more than in FY 2003;<sup>20</sup>

<sup>16</sup> The Housing and Economic Recovery Act of 2008 established the FTHBC under IRC § 36, which was initially applicable to residences purchased on or after Apr. 9, 2008, and before July 1, 2009. Pub. L. No. 110-289, § 3011, 122 Stat. 2654, 2888 (2008). Subsequent amendments to IRC § 36 further extended the credit to residences purchased before May 1, 2010. The American Recovery and Reinvestment Act of 2009 created the MWP credit under IRC § 36A, which is generally applicable for 2009 and 2010. Pub. L. No. 111-5, § 1001, 123 Stat. 115, 309 (2009). Pursuant to the PPACA a refundable credit under IRC § 36B for qualified health insurance premiums provides assistance to low income taxpayers. Pub. L. No. 111-148, § 1401, 124 Stat. 119, 213 (2010), as amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1001(a)(1)(A)-(B), 124 Stat. 1029, 1030 (2010) (effective for taxable years ending after 2013). The PPACA also added the Small Business Health Care Tax Credit, a credit for small business employee health insurance expenses, which may be partially refunded to certain tax-exempt entities. Pub. L. No. 111-148, § 1421, 124 Stat. 119, 237 (2010) (codified at IRC § 45R).

<sup>17</sup> See, e.g., TIGTA, Ref. No. 2009-30-141, *Improvements Are Needed in the Administration of Education Credits and Reporting Requirements for Educational Institutions* (Sept. 2009); TIGTA, Ref. No. 2009-40-057, *Actions Are Needed to Ensure Proper Use of Individual Taxpayer Identification Numbers and to Verify or Limit Refundable Credit Claims* (Mar. 31, 2009); TIGTA, Ref. No. 2010-41-011, *Evaluation of the Internal Revenue Service’s Capability to Ensure Proper Use of Recovery Act Funds* (Nov. 27, 2009); TIGTA, Ref. No. 2009-40-142, *The 2009 Filing Season Was Successful Despite Significant Challenges Presented by the Passage of New Tax Legislation* (Sept. 21, 2009); GAO, GAO-11-691T, *Enhanced Prerefund Compliance Checks Could Yield Significant Benefits* (May 25, 2011); *Improper Payments in the Administration of Refundable Tax Credits, Hearing Before the H. Subcomm. on Oversight, Comm. on Ways and Means* (May 25, 2011).

<sup>18</sup> The number of returns selected to be screened rose from 611,845 in CY 2010 to 1,054,704 in CY 2011, a 72 percent increase. W&I response to TAS information request (July 27, 2011, as updated Nov. 4, 2011).

<sup>19</sup> IRS Pub. 55B, Data Book, *Table 14, Information Reporting Program* (FY 2010) (10,554,735 math errors and 8,445,374 math error notices issued in FY 2010); IRS Pub. 55B, Data Book, *Table 26, Taxpayer Contact Information, by Type of Math Error and Selected program* (2003) (4,967,703 math error notices issued in 2003).

<sup>20</sup> IRS Pub. 55B, Data Book, *Table 14, Information Reporting Program* (FY 2010) (4,336,000 AUR contact closures in FY 2010); IRS Pub. 55B, Data Book, *Table 26, Taxpayer Contact Information, by Type of Math Error and Selected program* (2003) (1,561,068 AUR contact closures in FY 2003).

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- The Automated Substitute for Return (ASFR) program made 1,150,573 assessments in 2011 — 896 percent more than in FY 2003;<sup>21</sup> and
- The Correspondence Examination program, which uses automation more than the IRS's other audit programs, closed 1,238,632 examinations of individual returns in FY 2010 — 13 percent more than the prior year and 93 percent more than in FY 2003.<sup>22</sup>

Growth in these automated procedures dwarfs relatively small increases in traditional examination work. By comparison, examiners working outside of centralized processing centers closed only 342,762 examinations of individual returns in FY 2010 — five percent more than the prior year and 66 percent more than in FY 2003.<sup>23</sup>

Moreover, the IRS is likely to expand its reliance on automation as it receives, and attempts to process and use, more and more third-party data. For example, credit card issuers will soon be required to report the charges they process for businesses,<sup>24</sup> and brokerage firms generally will be required to report the cost basis (as well as gross proceeds) of stock, bond, and mutual fund sales.<sup>25</sup>

**If the IRS does not receive a response to computer-generated form letters, it assumes third-party data is correct and tax returns are not.**

When automated IRS systems identify mismatches between a return and third-party data, they generate letters, but the IRS rarely calls or visits the taxpayer or conducts any further investigation.<sup>26</sup> If the IRS does not receive and process a timely and satisfactory response, it may simply withhold the refund or assess additional tax, without ever being certain that the taxpayer's return (or decision not to file) was incorrect. The IRS assumes that if the return was correct, the taxpayer would have responded with additional documentation and an explanation.

<sup>21</sup> See 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*, *infra* (reflecting 1,150,573 ASFR assessments in FY 2011 and 128,319 in FY 2003).

<sup>22</sup> IRS Pub. 55B, Data Book, *Table 9a, Examination Coverage* (2010) (reflecting 1,581,394 examinations of individuals in FY 2010, 1,272,952 by correspondence from an IRS campus, and 342,762 in the field or from a field office); IRS Pub. 55B, Data Book, *Table 9a, Examination Coverage* (2009)), <http://www.irs.gov/pub/irs-soi/09databk.pdf> (reflecting 1,425,888 examinations of individual returns, 1,099,639 by correspondence from an IRS campus, and 326,249 in the field or from a field office); IRS Pub. 55B, Data Book, *Table 10, Examination Coverage* (2003), <http://www.irs.gov/pub/irs-soi/03databk.pdf> (reflecting 849,296 examinations of individual returns, 642,839 by correspondence from a compliance center, and 206,457 in the field or from a field office).

<sup>23</sup> *Id.* While 66 percent may seem significant, each of the increases in the automated programs cited above exceeded 66 percent.

<sup>24</sup> IRC § 6050W.

<sup>25</sup> IRC § 6045(g).

<sup>26</sup> For a discussion of this problem in the context of the ASFR program, see 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*, *infra*.

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**Accurate returns may appear to be inconsistent with third-party data, which can be unreliable or inconclusive.**

Longstanding IRS matching programs illustrate how third-party data are often unreliable when used as the sole basis to conclude that the taxpayer's return is wrong. For example, AUR assessments reflect mismatches between a tax return and data from third-party information returns, such as Forms W-2 and 1099. As we previously reported, 59 percent of the statutory notices of deficiency issued by the AUR program went unanswered in FY 2006, resulting in default assessments.<sup>27</sup> When taxpayers did respond, however, the IRS granted 88 percent of all AUR abatement requests.<sup>28</sup> Thus, even the most reliable third-party data — data from information returns — may be a weak basis on which to conclude that a taxpayer's return is wrong.<sup>29</sup> The data may be unreliable or the IRS may have failed to identify another reasonable explanation for the mismatch.

As another example, TAS studied a statistically valid sample of tax year 2009 accounts in which the IRS reversed its dependent Taxpayer Identification Number (TIN) math error corrections.<sup>30</sup> For these types of math errors, the IRS reversed itself 55 percent of the time. Moreover, TAS found that it could have resolved 56 percent of these errors using readily available internal data, rather than charging a math error and asking the taxpayer to explain the apparent discrepancy. Taking this action would have prevented math error notices and delays in releasing over 100,000 refunds.

As a final example, in the 1990s the IRS developed the Electronic Fraud Detection System to select questionable returns for “verification” prior to releasing refund claims as part of the IRS Criminal Investigation (CI) Division's Questionable Refund Program (QRP). Following a sharp increase in the number of taxpayers seeking assistance from the Taxpayer Advocate Service (TAS) because their refunds were delayed (or “frozen”) by the QRP, a 2005 TAS study suggested the QRP was not very good at identifying only questionable returns.

The TAS study found that in 66 percent of TAS's cases, the taxpayer received a full refund (or more) and in 80 percent of the cases the taxpayer received at least a partial refund.<sup>31</sup> These freezes were particularly appalling because the taxpayers in question really needed

<sup>27</sup> National Taxpayer Advocate 2007 Annual Report to Congress 259, 261 (Most Serious Problem: *Automated Underreporter*).

<sup>28</sup> *Id.* (citing data for FY 2006). The IRS granted 83.3 percent of all AUR abatement requests in FY 2011. IRS, Enforcement Revenue Information System Summary Database (Dec. 2011).

<sup>29</sup> According to TIGTA, more than two billion information returns were submitted to the IRS in TY 2007, of which almost 31.7 million had invalid payee data (1.5 percent). TIGTA, Ref. No. 2011-30-019, *Targeted Compliance Efforts May Reduce the Number of Inaccurate Information Returns Submitted by Government Entities* 3-4 (Feb. 15, 2011). Because third-party information returns can be unreliable and difficult for a taxpayer to disprove, the IRS is not always entitled to rely on its general presumption of correctness in court when its determination is based on them. See, e.g., *Portillo v. Comm'r*, 932 F.2d 1128 (5th Cir. 1991); IRC § 6201(d). For further discussion of this issue, see *An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*, vol. 2 *infra*.

<sup>30</sup> *Math Errors Committed on Individual Tax Returns: A Review of Math Errors Issued for Claimed Dependents*, vol. 2, *infra*.

<sup>31</sup> National Taxpayer Advocate 2005 Annual Report to Congress vol. 2, 1, 2 (*Criminal Investigation Refund Freeze Study*).

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them quickly — their median income was \$13,330 and their median refund was \$3,519.<sup>32</sup> Yet, the IRS presumed these low income taxpayers had submitted fraudulent refund claims, delayed their refunds by a median of 8.5 months, and refused to provide any explanation to them.<sup>33</sup>

The AMTAP, which is the successor to CI's QRP, presents similar concerns. TAS analyzed the results of approximately 20,000 cases closed in FY 2011 involving taxpayers who sought TAS assistance with refund delays related to AMTAP. The IRS agreed to grant full or partial relief to taxpayers in 79.8 percent of these cases.<sup>34</sup>

**Taxpayers whose returns are correct may not respond to IRS letters because of communication difficulties.**

*IRS letters do not always reach taxpayers.*

About ten percent of the IRS's mail is returned.<sup>35</sup> As a result, a significant number of taxpayers do not respond to IRS letters because they do not receive them.

*IRS letters are often difficult to understand.*

Even if a taxpayer receives the IRS's letter, computer-generated form letters are often difficult to understand.<sup>36</sup> A 2004 TAS Research study found that in EITC "no response" audit cases where taxpayers later sought an audit reconsideration, 43 percent were entitled to essentially all of the EITC claimed on their original returns.<sup>37</sup> In a follow-up survey of taxpayers subject to EITC audits, more than one quarter indicated they did not understand that the IRS was auditing their return, almost 40 percent did not understand what the IRS was questioning about their EITC claim, and only about half felt that they knew what they needed to do in response to the audit letter.<sup>38</sup>

<sup>32</sup> National Taxpayer Advocate 2005 Annual Report to Congress 25, 26 (Most Serious Problem: *Criminal Investigation Refund Freezes*).

<sup>33</sup> Following publication of these findings and the resulting congressional and public outcry, the IRS agreed to dramatically alter these procedures, but similar procedures remain as part of AMTAP. See Most Serious Problem: *The IRS's Wage and Withholding Verification Procedures May Encroach on Taxpayer Rights and Delay Refund Processing, infra*.

<sup>34</sup> See *id.*

<sup>35</sup> TIGTA, Ref. No. 2010-40-055, *Current Practices Are Preventing a Reduction in the Volume of Undelivered Mail 1* (May 14, 2010). For further discussion of the problem, see National Taxpayer Advocate 2010 Annual Report to Congress 221-234 (Most Serious Problem: *The IRS Has Not Studied or Addressed the Impact of the Large Volume of Undelivered Mail on Taxpayers*).

<sup>36</sup> For a discussion of communication problems, see for example, National Taxpayer Advocate 2008 Annual Report to Congress 227, 230 (Most Serious Problem: *Suitability of the Examination Process*) (noting that more than 50 percent of the taxpayers audited by correspondence did not respond to the IRS's letters, and that 26.5 percent of the respondents to a TAS survey were not even aware the IRS was auditing their returns) and National Taxpayer Advocate 2011 Annual Report to Congress vol. 2 (*An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*) (discussing the potential confusion generated by various IRS letters).

<sup>37</sup> See National Taxpayer Advocate 2004 Annual Report to Congress vol. 2, 9 (*EITC Audit Reconsideration Study*). These taxpayers were entitled to an average of 96 percent of the EITC they originally claimed. *Id.*

<sup>38</sup> National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 103-104 (*IRS Earned Income Credit Audits — A Challenge to Taxpayers*). Another TAS study found that taxpayers who used a representative during the audit process were nearly twice as likely to be determined EITC eligible when compared to those without representation. *Id.* at 108.

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*The IRS does not always answer the phone.*

Even if a taxpayer generally understands the IRS's letter, he or she will often want to call the IRS for clarification before responding.<sup>39</sup> However, taxpayers often have difficulty reaching the IRS by phone.<sup>40</sup> For example, as previously reported, the AUR toll-free operation only answered between 70 and 74 percent of the calls it received.<sup>41</sup> When taxpayers did reach the IRS by phone, the person they reached was rarely able to resolve the issue.<sup>42</sup>

*The IRS does not always timely respond by mail.*

Even if a taxpayer responds by mail, the IRS does not always timely process the response.<sup>43</sup> For example, a recent report suggested the IRS was late in responding to math error submissions about 40 percent of the time.<sup>44</sup>

At some point, taxpayers are going to give up. As a result, the IRS's assumption — that if it does not receive a written response from the taxpayer, the return must be wrong — is often incorrect. Thus, as described in more detail in the MSPs that follow, the IRS should do more to avoid harming taxpayers who are sincerely trying to comply by making it easier for them to communicate with the IRS.

**The IRS's assumptions may have a disparate impact on low income taxpayers.**

Improper claims for refundable credits such as the EITC, which are aimed at low and middle income taxpayers, account for a fairly small proportion of the overall tax gap. Underreporting by unincorporated businesses cost the government \$109 billion in 2001 (the latest year for which data are available), dwarfing the \$17 billion lost to improper claims for credits by more than six to one.<sup>45</sup> The net misreporting percentage for nonfarm proprietor income is 57.1 percent, as compared to 26.3 percent for credits.<sup>46</sup> Moreover, part

<sup>39</sup> The EITC survey results (cited above) indicate that:

Even though slightly over half of the respondents indicated that they understood what was being questioned and knew what they needed to do, overall, more than 90 percent contacted the IRS. Seventy-two percent of the respondents said that they either called or visited the IRS in response to the letter. More than 75 percent of those taxpayers contacting the IRS about their audit letter did so by telephone.

*Id.* at 104.

<sup>40</sup> See, e.g., National Taxpayer Advocate 2009 Annual Report to Congress 4 (Most Serious Problem: *IRS Toll-Free Telephone Service Is Declining as Taxpayer Demand for Telephone Service Is Increasing*) (noting that even if the IRS were to reach its goals for FY 2010, nearly three in ten callers would not get through, and those that did would have to wait nearly 12 minutes on hold before reaching a person).

<sup>41</sup> National Taxpayer Advocate 2007 Annual Report to Congress 259, 262-263 (Most Serious Problem: *Automated Underreporter*) (a sample of TAS cases indicated that most (57 percent) had previously called or written AUR without resolution and 21 percent were calling because they received no response from the IRS).

<sup>42</sup> National Taxpayer Advocate 2007 Annual Report to Congress 259, 271 (Most Serious Problem: *Automated Underreporter*) (noting that when callers did get through to the AUR toll-free operation the IRS resolved just seven percent of the cases).

<sup>43</sup> See, e.g., National Taxpayer Advocate 2010 Annual Report to Congress 235 (Most Serious Problem: *The IRS Does Not Process Vital Taxpayer Responses Timely*) (noting that over 75 percent of IRS correspondence received in two Compliance Service Collection Operations took more than 14 days to be processed and that for all Correspondence Imaging System cases closed in FY 2009, it took between 15 and 30 days to assign the correspondence).

<sup>44</sup> TIGTA, Ref. No. 2011-40-059, *Some Taxpayer Responses to Math Error Adjustments Were Not Worked Timely and Accurately* 4 (July 7, 2011) (Figure 3).

<sup>45</sup> IRS, *Tax Gap Map for Year 2001* (Feb. 2007), available at [http://www.irs.gov/pub/irs-utl/tax\\_gap\\_update\\_070212.pdf](http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf).

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

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of the IRS's job should be to get eligible taxpayers to claim the EITC, rather than discouraging them from claiming it by making the credit an audit trigger.

Recognizing that an excessive number of EITC audits would disproportionately burden low income taxpayers and would not be an efficient use of scarce audit resources, the IRS set an internal cap on the number of EITC audits it would undertake.<sup>47</sup> Pursuant to new AMTAP and math error procedures, however, the IRS plans to check more returns from low income taxpayers where the errors are “below tolerance” (*i.e.*, not considered significant enough to warrant a “real” examination) — precisely the taxpayers who are most likely to have difficulty communicating with the IRS. The National Taxpayer Advocate is concerned that these new streamlined procedures bypass key taxpayer rights that the IRS routinely provides to high income taxpayers who are subject to “real” examinations.

#### **Summary assessment procedures may bypass taxpayer rights.**

##### *Traditional examination procedures protect taxpayer rights.*

In connection with an examination, the taxpayer has the right to:<sup>48</sup>

1. Avoid repetitive and unnecessary examinations;<sup>49</sup>
2. Avoid an audit based on financial status;<sup>50</sup>
3. Be informed before the IRS contacts third parties;<sup>51</sup>
4. Be informed about how the IRS selects returns for examination;<sup>52</sup>
5. Be informed about the right to be represented in any interview;<sup>53</sup>
6. Be examined at a reasonable time and place;<sup>54</sup>

<sup>47</sup> See, e.g., TIGTA, Ref. No. 2008-40-131, *While Progress Has Been Made, Limits on the Number of Examinations Reduce the Effectiveness of the Earned Income Tax Credit Recertification Program* (July 3, 2008), which explained:

Beginning in Calendar Year (CY) 2005, the IRS Commissioner set a case limitation (or ‘cap’) on the number of EITC-related returns.... the IRS began using a dollar tolerance to limit the number of EITC related returns ... sent to the Examination function...[the IRS stated that] imposing the cap shifted resources to other areas to improve overall audit coverage. The IRS also noted that setting a tolerance allows the IRS to conduct more higher-yielding audits...

*Id.*

<sup>48</sup> See generally IRS, Pub. 1, *Your Rights as a Taxpayer* (2005); IRS, Pub. 556, *Examination of Returns, Appeal Rights and Claims for Refund* (2008); IRS, Pub. 3498-A, *The Examination Process* (2004). The National Taxpayer Advocate has recommended legislation to codify more taxpayer rights. See *Enact Previous Recommendations of the National Taxpayer Advocate to Protect Taxpayer Rights, infra*. See also National Taxpayer Advocate 2007 Annual Report to Congress 478-489.

<sup>49</sup> IRC § 7605(b); Policy Statement 4-3 (Dec. 21, 1984), *reprinted at* IRM 1.2.13.1.1 (Aug. 31, 2007); 26 C.F.R. § 601.105(j) (statement of procedural rules).

<sup>50</sup> IRC § 7602(e).

<sup>51</sup> IRC § 7602(c).

<sup>52</sup> The IRS Restructuring and Reform Act of 1998 (RRA 98), Pub. L. No. 105-206, § 3503, 112 Stat. 685, 771 (1998).

<sup>53</sup> RRA 98 § 3502, 112 Stat. 685, 770 (1998).

<sup>54</sup> IRC § 7605(a) (“The time and place of examination ... shall be ... reasonable under the circumstances.”).

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7. Receive an explanation of the examination and appeals process;<sup>55</sup>
8. Receive an explanation of the IRS’s “determination;”<sup>56</sup>
9. Appeal the IRS’s determination to the United States Tax Court before paying;<sup>57</sup>
10. Require the IRS to bear the burden of proving in the Tax Court that its determination is correct, provided the taxpayer cooperated with the IRS and met certain other conditions;<sup>58</sup> and
11. Receive compensation for administrative and litigation costs if the IRS position was largely unjustified and other conditions are satisfied.<sup>59</sup>

***Automated procedures may jeopardize taxpayer rights.***

When IRS systems adjust a return based on mismatches, the adjustment is not an “examination,” according to the IRS.<sup>60</sup> Thus, some of the rights associated with an examination do not apply to the IRS’s automated matching procedures. For example, the right to avoid unnecessary and repetitive examinations of the same return does not apply.<sup>61</sup> Similarly, the IRS uses streamlined assessment procedures to make “math error” adjustments.<sup>62</sup> Under these procedures, the taxpayer is required to respond more quickly than if they had been examined (within 60 days, rather than 90 days or more), or risk losing the right to appeal the adjustment to the Tax Court.<sup>63</sup>

***The IRS does not always explain what taxpayer rights apply to its new automated procedures.***

When the IRS sends a taxpayer a letter pursuant to one of its automated procedures, it does not always explain what procedures apply. Nor does it explain which of the rights

<sup>55</sup> RRA 98 § 3504, 112 Stat. 685, 771 (1998) (“include with any first letter of proposed deficiency which allows the taxpayer an opportunity for administrative review in the Internal Revenue Service Office of Appeals an explanation of the entire process from examination through collection with respect to such proposed deficiency, including the assistance available to the taxpayer from the National Taxpayer Advocate at various points in the process.”). The IRS generally includes Publication 1 in the so-called 30-day letter.

<sup>56</sup> IRC § 6212; see generally 26 C.F.R. § 601.105(d) (statement of procedural rules); IRC § 6402(l) (“In the case of a disallowance of a claim for refund, the Secretary shall provide the taxpayer with an explanation for such disallowance.”).

<sup>57</sup> IRC § 6213(a).

<sup>58</sup> IRC §§ 6201(d) and 7491.

<sup>59</sup> IRC § 7430.

<sup>60</sup> See, e.g., Rev. Proc. 2005-32, § 4.03(d)(iii)(B), 2005-1 C.B. 1206 (excluding from the definition of examination, “adjustments resulting from ... a discrepancy between a filed tax return and information received from a third party or a federal or state governmental databank; or ... an information-return matching program, or other correction programs operated by Internal Revenue Service Centers or Campuses”). Similarly, at least one IRS attorney has concluded that an ASFR does not constitute an examination. CCA 200518001 (May 6, 2005).

<sup>61</sup> Rev. Proc. 2005-32, § 4.03, 2005-1 C.B. 1206.

<sup>62</sup> For a discussion of math error procedures and recommendations for improving them, see, e.g., Most Serious Problem: *Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights*, *infra*; and Legislative Recommendation: *Mandate that the IRS, in Conjunction with the National Taxpayer Advocate, Review any Proposed Expanded Math Error Authority to Protect Taxpayer Rights*, *infra*.

<sup>63</sup> A taxpayer has no right to petition the Tax Court upon receipt of a math error notice. IRC § 6213(b)(1). If the taxpayer responds to the notice within 60 days after the IRS mails it by requesting an abatement, however, the IRS will (at least temporarily) abate the assessment specified in the notice. IRC § 6213(b)(2). The IRS would have to use normal procedures to (re)assess any deficiency. A taxpayer normally has at least 90 days to petition the Tax Court after the IRS mails a statutory notice of deficiency. IRC § 6213(a).

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normally associated with examinations apply in connection with its matching programs and which do not.<sup>64</sup> If taxpayers do not know about their rights, they cannot invoke them. Unfortunately, it is easy to find examples of this problem.

#### **AMTAP USED LETTER 105C INAPPROPRIATELY.**

As described in the MSP entitled *Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights*, the IRS improperly attempted to use math error authority to recover the FTHBC based on third-party data. Third-party data suggested that some taxpayers may have purchased their homes before the effective date of the credit. The IRS issued Letter 105C, *Claims Disallowed*, to 36,000 taxpayers.<sup>65</sup> However, the IRS does not have the authority to recover the FTHBC in this manner.<sup>66</sup> Before the IRS can make such an adjustment, it is legally required to issue a so-called “statutory notice of deficiency,”<sup>67</sup> which gives the taxpayer the right to petition the Tax Court.<sup>68</sup>

In addition, Letter 105C was confusing and misleading to taxpayers who had already received the credit. The letter stated a taxpayer could only appeal the IRS determination to Appeals if the IRS disallowed the claim because it was late.<sup>69</sup> These taxpayers had not filed late claims. If they had, they would not have received the FTHBC. The IRS had to send a second letter to these 36,000 taxpayers apologizing for the confusion and indicating the credit was “not disallowed.”<sup>70</sup>

#### **AUR’S CP 2000 DOES NOT EXPLAIN THAT THE IRS COULD EXAMINE THE RETURN AGAIN.**

The CP 2000 letter, which the IRS uses to initiate the AUR process, is also somewhat ambiguous. It suggests to the taxpayer that he or she is under examination. Under the heading of “What steps should I take?” the CP 2000 provides “Review your rights in the Examination Process Booklet (enclosed).” On the first page of text in the enclosed booklet, it says: “Your return is going to be examined.” It does not warn the taxpayer that the IRS does not consider an AUR to be an examination for purposes of the right not to have the same return examined again.<sup>71</sup> Thus, the CP 2000 is confusing because it may appear to

<sup>64</sup> The letter that the IRS is using in connection with its AQR program does not use the word “audit” or “examination,” but nonetheless includes Publication 1, which only describes the taxpayer rights associated with the examination, collection, or appeals process.

<sup>65</sup> IRS response to TAS information request (Sept. 13, 2011).

<sup>66</sup> The IRS was making an adjustment based on inconsistencies between the date of purchase shown on the return and the date of purchase reflected in third-party data. The IRS’s general authority to make math error adjustments under IRC § 6213(g)(2)(C) applies only when one item on a return is inconsistent with another. We understand the IRS mistakenly believed, based on an informal discussion with Counsel, that it could use math error authority to make the reversals.

<sup>67</sup> IRC § 6212.

<sup>68</sup> IRC § 6213(a).

<sup>69</sup> Letter 105C, *Claim Disallowed* (May 3, 2010) (“You may appeal our decision with the Appeals Office (which is independent of our office) if we disallowed your claim because our records show that you filed your claim late.”).

<sup>70</sup> SERP Alert 110544 (Aug. 4, 2011).

<sup>71</sup> See, e.g., Rev. Proc. 2005-32, § 4.03, 2005-1 C.B. 1206.

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conflict with the IRS's legal position that an AUR is not an examination for purposes of the no-repetitive-examination rule.

#### **AQR'S LETTER 4800C DOES NOT INDICATE WHICH PROCEDURES APPLY.**

As discussed in the MSP entitled, *The IRS's Wage and Withholding Verification Procedures May Encroach on Taxpayer Rights and Delay Refund Processing*, Letter 4800C, which the IRS uses to initiate the AQR process, is similarly confusing. It does not refer to the inquiry as an audit or examination. However, the IRS includes Publication 1 as an attachment to the letter. Publication 1 explains examination, collection and appeals procedures, but not AQR procedures. As with an AUR, some taxpayers might conclude they are under examination and assume the IRS will not examine them again. After all, Publication 1 explains that the IRS will generally not examine returns more than once. The letter does not warn the taxpayer that the IRS does not consider the AQR process to be an examination for purposes of the right not to have the same return examined again, or that the IRS may actually examine the same return after closing the AQR inquiry.<sup>72</sup>

## **CONCLUSION**

The IRS is increasingly relying on unexplained data mismatches to adjust a person's liability and to deny or delay refunds to those in need. Matching programs that rely primarily on third-party data are not always accurate. Some mismatches will remain unexplained for a wide variety of reasons, even if the taxpayer's return is correct. Thus, the IRS's adjustment will be inaccurate in many cases and taxpayers will be harmed. Moreover, by defining these procedures as "not an examination," without explaining what they are and what procedures 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, and do so without informing taxpayers.

As described in the following MSPs, the IRS's approach will be balanced only if:

- **The IRS's automated systems use only the most reliable data.** For example, the MSPs entitled "*The IRS's Wage and Withholding Verification Procedures May Encroach on Taxpayer Rights and Delay Refund Processing*," "*Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights*," and "*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*," each raise concerns about the IRS's use of third-party data.<sup>73</sup>

<sup>72</sup> If a return involves more than one issue, AQR should refer it for a "real" examination. If AQR issues a statutory notice and the taxpayer files a petition in the Tax Court, the IRS may not be able to reopen the return in any event. See IRC § 6212(c)(1) (stating that with certain exceptions, after a taxpayer files a petition with the Tax Court, "the Secretary shall have no right to determine any additional deficiency of income tax for the same taxable year ...with respect to any act (or failure to act) to which such petition relates").

<sup>73</sup> While appearing later in the report, the Most Serious Problem entitled "*The IRS Should Reevaluate Earned Income Tax Credit Compliance Measures and Take Steps to Improve Both Service and Compliance*" raises many of the same concerns.

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- **The IRS's letters reach taxpayers and clearly explain the discrepancy along with any applicable procedures and taxpayer rights.** These MSPs identified above also raise concerns about IRS correspondence.
- **The IRS's mitigation procedures make it easy for taxpayers to communicate with the IRS to explain apparent discrepancies and resolve problems.** Each of these MSPs raises concerns about the burden that taxpayers may face in responding to automated IRS procedures. Similarly, the MSP entitled "*Tax-Related Identity Theft Continues to Impose Significant Burdens on Taxpayers and the IRS*" raises concerns about the burdens that identity theft victims may face.

MSP  
#2**The IRS's Wage and Withholding Verification Procedures May Encroach on Taxpayer Rights and Delay Refund Processing****RESPONSIBLE OFFICIALS**

Richard E. Byrd Jr., Commissioner, Wage and Investment Division  
Jodi Patterson, Director, Return Integrity and Correspondence Services

**DEFINITION OF PROBLEM**

As the nation's tax collection agency, the IRS is responsible for processing over 141 million individual income tax returns annually, including nearly 120 million requests for refunds.<sup>1</sup> As part of this process, it must protect the public fisc from illegitimate refund requests while expeditiously processing legitimate tax returns and paying out legitimate refund claims. The dual tasks of fraud prevention and timely processing of returns present challenges even in the simplest of 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, and to better protect the public fisc from 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.

In fiscal year 2011, the Accounts Management Taxpayer Assurance Program (AMTAP) delayed nearly two million refund claims, identifying them as questionable or potentially fraudulent.<sup>2</sup> The Electronic Fraud Detection System (EFDS), which the IRS claims had an 89 percent accuracy rate in 2011, selected over one million returns for screening, a 72 percent increase from the previous year.<sup>3</sup> In addition to these questionable refund claims selected by EFDS, AMTAP also identified 893,000 returns as part of the Operation Mass Mail (OMM) scheme in CY 2011 — and has no plans to process such OMM returns.<sup>4</sup>

<sup>1</sup> In fiscal year (FY) 2010, the IRS processed 141,617,000 individual tax returns. IRS 2010 Data Book, Table 2, *Number of Returns Filed by Type of Return, Fiscal Year 2010*. In FY 2010, the IRS processed 119,443,586 refund requests. IRS 2010 Data Book, Table 7, *Number of Refunds Issued by Type of Refund and State, Fiscal Year 2010*.

<sup>2</sup> The Electronic Fraud Detection System (EFDS) is one tool the IRS uses to select questionable returns for "verification" prior to releasing refunds. EFDS selected 1,054,704 questionable returns for screening in calendar year (CY) 2011. The IRS stopped an additional 893,267 potentially fraudulent returns as part of the Operation Mass Mail (OMM) program. See Wage and Investment (W&I) division response to TAS information request (July 27, 2011, and updated Nov. 4, 2011).

<sup>3</sup> The volume of returns selected to be screened rose from 611,845 in CY 2010 to 1,054,704 in CY 2011 (through Oct. 15, 2011), a 72 percent increase. See W&I response to TAS information request (July 27, 2011, and updated Nov. 4, 2011). By the IRS's own estimation, it was unable to "verify bad" 11 percent of these returns, leaving up to 116,000 potentially "good" taxpayers improperly caught up in the EFDS filter. Of the approximately 20,600 pre-refund cases TAS closed in FY 2011, more than 16,000 taxpayers (79.8 percent) obtained relief. So by comparing these two numbers, it is reasonable to conclude that potentially 100,000 innocent taxpayers who did not come to TAS were harmed by the EFDS filter in 2011.

<sup>4</sup> AMTAP identified 893,267 OMM returns through October 15, 2011. Email from AMTAP analyst (Nov. 4, 2011).

While the number of returns screened by EFDS rose by 72 percent, AMTAP staffing grew by less than nine percent,<sup>5</sup> causing inventory to soar to 690,000 cases at one point during the 2011 filing season.<sup>6</sup> As inventory levels increase, so do the delays in responding to legitimate refund claims. Although the manual process of verifying the taxpayer's wages and withholding is supposed to take 13 weeks or less, in practice the delay could be much longer.

In an effort to better understand the reasons for the significant increase in pre-refund cases, we conducted a study of a statistically representative sample of TAS's pre-refund wage verification cases closed in FY 2011 (hereinafter the "TAS study").<sup>7</sup> In these cases, the average refund amount was over \$5,600 (median refund was approximately \$4,100), and the average delay was 25 weeks (median delay was slightly under 19 weeks). Requiring legitimate taxpayers to wait nearly half a year to receive refunds of this magnitude often imposes significant financial hardships. TAS found that the IRS had placed a hard freeze on the taxpayer's account in at least 50 percent of the cases in this sample, with taxpayers obtaining relief in 84 percent of the time.<sup>8</sup>

TAS often feels the effects of systemic problems within the IRS. In FY 2011, TAS received over 21,000 pre-refund cases, a 504 percent increase over cases received in FY 2010.<sup>9</sup> Such cases constituted 7.2 percent of all TAS case receipts in FY 2011.<sup>10</sup> Notably, we found that taxpayers coming to TAS with pre-refund problems ultimately received relief 75 percent of the time.

TAS typically issues one or more Operations Assistance Requests (OARs) to IRS functions to resolve open cases. In FY 2011, TAS issued nearly 25,000 OARs to AMTAP.<sup>11</sup> The unit did not complete the requested actions within three days of the negotiated timeframe on approximately 4,600 of those OARs – over 18 percent of the OARs issued to AMTAP.<sup>12</sup> To get AMTAP's attention, Local Taxpayer Advocates issued 210 Taxpayer Assistance Orders

<sup>5</sup> The AMTAP staff increased from 336 in FY 2010 to 366 in FY 2011, a gain of nearly nine percent. See W&I response to TAS information request (July 27, 2011).

<sup>6</sup> TAS notes from IRS Decedent Schemes conference call (Apr. 25, 2011).

<sup>7</sup> TAS analyzed Compliance Data Warehouse (CDW) data from the Individual Returns Transaction File of 373 closed TAS cases with primary issue code (PIC) 045 (Pre-Refund Wage Verification) and PIC 425 (Stolen Identity) with secondary issue code (SIC) 045 cases pulled on October 11, 2011 (hereinafter "TAS Study"). The 373 cases are a representative sample of the FY 2011 TAS PIC 045 and PIC 425 SIC 045 cases. The sample has a margin of error of plus or minus 5.1 percent at a confidence level of 95 percent. The TAS study is not a representative sample of all IRS AMTAP cases.

<sup>8</sup> See TAS Study. Hard freezes were almost certainly applied in additional cases. In some instances, the IRS may apply a hard freeze by inputting a second TC 570. Because the master file does not capture when a second TC 570 is input, TAS included in its count of hard freezes only cases that contained RCC 3 and TC 841 codes in the 373-case sample.

<sup>9</sup> TAS, Business Performance Review (4th Quarter FY 2011). The 21,286 pre-refund wage verification (PIC 045) cases actually represent a 571 percent increase over the 3,171 PIC 045 cases received in FY 2010. However, because TAS did not use PIC 045 until March 24, 2010, a more appropriate comparison would be between PIC 045 case receipts from the last two quarters of FY 2011 (18,018 cases) and the last two quarters of FY 2010 (2,981 cases), which represents a 504 percent increase. See TAS, Business Performance Review (4th Quarter FY 2010 and 4th Quarter FY 2011).

<sup>10</sup> TAS received 295,904 cases in FY 2011. See TAS Business Performance Review (4th Quarter FY 2011).

<sup>11</sup> TAS issued 24,911 OARs to TAMIS in FY 2011. Data obtained from Taxpayer Advocate Management System (TAMIS) (Nov. 2, 2011).

<sup>12</sup> AMTAP did not complete the requested action within three days of the negotiated timeframe in 4,606 OARS in FY 2011. Data obtained from TAMIS (Nov. 2, 2011).

(TAOs) to AMTAP in FY 2011, approximately equal to the number issued to all other IRS functions combined, and more than TAS has issued to the IRS in any preceding year.<sup>13</sup> Given that Local Taxpayer Advocates had such difficulty getting AMTAP to respond to their requests for help and directions for action, it seems likely that taxpayers who proceeded without TAS assistance faced even greater resistance.

The prevalent use of refund freezes is reminiscent of the IRS Criminal Investigation (CI) division's prior practice of freezing refund claims through its Questionable Refund Program (QRP). In her 2005 Annual Report to Congress, the National Taxpayer Advocate criticized the QRP for, among other problems, freezing the legitimate refunds of tens of thousands of taxpayers without notifying them or giving them an opportunity to respond.<sup>14</sup> In response to the National Taxpayer Advocate's concerns, the IRS moved the refund verification process from CI to the Wage and Investment (W&I) division in 2009. Although the IRS has expanded its notification process to alert most taxpayers whose returns face verification, many of our concerns remain, including:

- The IRS should limit its use of hard refund freezes to cases that exhibit clear indicia of fraud. Hard freezes should never be used simply as an inventory management tool.
- AMTAP selects more returns than ever but relies on screens based on imperfect data, increasing the risk of taxpayer harm.
- The IRS does not notify taxpayers when it "auto-voids" certain suspicious refund claims.
- The IRS does not have sufficient staffing and systems resources to keep up with its mounting AMTAP inventory.<sup>15</sup>
- The IRS should be careful not to abridge taxpayer rights as it proposes new initiatives to address questionable refunds.

## ANALYSIS OF PROBLEM

### Background

At the time that the National Taxpayer Advocate identified refund freezes as a most serious problem in her 2005 Annual Report to Congress, the IRS Criminal Investigation function

<sup>13</sup> Internal Revenue Code (IRC) § 7811 authorizes the National Taxpayer Advocate to issue a Taxpayer Assistance Order when a taxpayer is suffering or about to suffer a significant hardship as a result of the manner in which the internal revenue laws are being administered if relief is not granted. See IRC § 7811(a)(1); IRM 13.1.20.1 (Dec. 15, 2007). TAS issued a total of 422 TAOs in FY 2011. In FY 2010, TAS issued a total of 95 TAOs. TAS, Business Performance Review (4th quarter FY 2011).

<sup>14</sup> See National Taxpayer Advocate 2005 Annual Report to Congress 25 (Most Serious Problem: *Criminal Investigation Refund Freezes*); National Taxpayer Advocate 2005 Annual Report to Congress vol. 2 (*Criminal Investigation Refund Freeze Study*). See also National Taxpayer Advocate 2006 Annual Report to Congress 408 (Status Update: *Major Improvements in the Questionable Refund Program and Some Continuing Concerns*).

<sup>15</sup> EFDS is operating at maximum capacity, meaning the system cannot accept any more new users or data without first deleting current users or data.

(CI) was operating the QRP.<sup>16</sup> Following a 400 percent increase in TAS cases originating from CI, TAS conducted a research study that found that taxpayers in over 80 percent of the decided cases in the statistically representative case sample received at least a partial refund (66 percent had received a full refund) and that taxpayers had to wait about nine months, on average, to receive these refunds.<sup>17</sup> As part of the study, TAS learned that well over 200,000 taxpayers with frozen refunds never received any notice of CI's actions, and CI had taken no action to resolve those disputed refund claims.<sup>18</sup>

Following the National Taxpayer Advocate's 2005 report and consequent congressional and public criticism, the IRS agreed to dramatically alter the QRP procedures, including transitioning them out of CI and into W&I.<sup>19</sup> The Commissioner established an Executive Steering Committee consisting of representatives from CI, TAS, the Examination functions of W&I and the Small Business/Self-Employment Division (SB/SE), the Accounts Management function in W&I, and Modernization & Information Technology Services. After weeks of negotiations, a memorandum of understanding (MOU) regarding revised QRP procedures was agreed to by the National Taxpayer Advocate; Chief, CI; Commissioner, W&I; and Commissioner, SB/SE.<sup>20</sup> The 2006 MOU set forth the following process:

1. The IRS can delay processing of refund claims for up to 14 days in order to identify questionable claims. CI will then have to either post the return and release the refund or temporarily freeze the refund claim for further investigation.
2. If it chooses the temporary freeze, CI will have up to 70 days (*i.e.*, ten weeks or "processing cycles") from the date the return is posted either to release the refund or to impose a hard freeze on the claim.
3. If CI imposes a hard freeze, its employees must decide within a reasonable time whether to investigate the case as part of a fraudulent scheme, refer the case to the IRS Compliance function for further investigation, disallow the claim, or release the refund.

In October 2009, W&I fully assumed responsibility over the QRP, under the Accounts Management Taxpayer Assurance Program (AMTAP). In October 2011, the group moved

<sup>16</sup> The National Taxpayer Advocate made the following recommendations in her 2005 Annual Report to Congress: (1) the IRS should notify all taxpayers within two weeks whenever it places a freeze on a refund claim; (2) once CI "determines" that fraud exists, it should immediately refer the case to the Examination function or it should immediately notify the taxpayer of his or her right to file a refund suit in court; (3) the IRS should give serious consideration to moving the initial screening outside the CI function; (4) the IRS should devote additional resources to improving the accuracy of its screening methods; (5) the IRS should review CI's policy of freezing refunds for a certain number of years after it "determines" fraud on a taxpayer's return; (6) CI should facilitate a study of a random sample of frozen-refund cases in which the affected taxpayers have not contacted TAS; and (7) when releasing reports of revenue protected by the QRP, the IRS should be more complete in describing the achievements and limitations of the QRP. See National Taxpayer Advocate 2005 Annual Report to Congress 52-54.

<sup>17</sup> National Taxpayer Advocate 2005 Annual Report to Congress vol. 2, 2.

<sup>18</sup> National Taxpayer Advocate 2006 Annual Report to Congress 411.

<sup>19</sup> See New York Times, *Editorial: Guilty Until Proven Innocent* (Jan. 20, 2006); Tax Notes, *Players In IRS Restructuring Effort Distressed By Frozen Refunds*, 2006 TNT 9-1 (Jan. 12, 2006); Tax Notes, *Editorial: The Refund Freeze Program Warrants Outrage* (Jan. 18, 2006); Tax Notes, *Senate Democrats Ask Snow to Examine IRS Questionable Refund Program* (Jan. 23, 2006); Tax Notes Today, *Capitol Hill Hot Over Frozen Refunds*, 2006 TNT 13-1 (Jan. 19, 2006).

<sup>20</sup> See Memorandum Regarding IRS Criminal Investigation Questionable Refund Program Procedures (Feb. 3, 2006).

from Accounts Management to a newly created W&I organization called Return Integrity & Correspondence Services.

AMTAP's main objective as a pre-refund revenue protection program is to identify and stop fraudulent refunds primarily generated as a consequence of misreported wages and withholding. The Electronic Fraud Detection System, built in the 1990s, filters all refund returns pursuant to business rules designed to distinguish good returns from bad ones, and it flags returns with a high perceived risk of fraud.<sup>21</sup>

When EFDS selects a return for screening, the return is "re-sequenced" (*i.e.*, the posting of return information is delayed) for up to 14 days. If the return screening suggests the likelihood of fraud, AMTAP places a temporary refund freeze on the account for 11 weeks to allow time for wage and withholding verification. AMTAP sends a letter informing the taxpayer that income, withholding, or tax credits are being "reviewed" and that the refund is being held for a more thorough assessment.<sup>22</sup>

One method AMTAP uses to verify return information during this review period is to compare it with the Information Returns Master File (IRMF).<sup>23</sup> However, IRMF information for the prior year is not available until mid-May (one month after the regular April 15 filing deadline).<sup>24</sup> If the IRMF were available in real time, or even a month earlier, it would alleviate a great deal of burden for the thousands of taxpayers whose refunds are held up for wage withholding "verification."<sup>25</sup> Notably, the IRS does obtain wage and withholding data from certain large employers in real time, which enables the IRS to conduct some real time matching.

If AMTAP cannot initially verify wage and withholding documents through systemic filters, it moves on to a manual "verification" process. AMTAP employees attempt to contact the employer to verify the amounts reported on the return via disc, fax, or phone.<sup>26</sup> If AMTAP verifies the wages and withholding as accurate, the IRS will release the refund.

<sup>21</sup> Based on prior years' returns, including those involving "verified" fraud, models are built and implemented for detecting fraud. Incoming returns requesting refunds are passed through the knowledge base and scored for likelihood of fraud. Returns that are flagged are diverted into a workload for further inspection before any refund is issued. Kenneth A. Kaufman, *An Analysis of Data Mining in the Electronic Fraud Detection System* (Apr. 28, 2010).

<sup>22</sup> Notice CP 05, *Information Regarding Your Refund*.

<sup>23</sup> The IRMF contains third party information including wage and withholding reported on Forms W-2 *Wage and Tax Statement*, and most Forms 1099, *U.S. Information Return*. Under present law, issuers who file these forms electronically have until March 31 to file them with the government. Issuers send Forms 1099 directly to the IRS and Forms W-2 directly to the Social Security Administration (SSA), which in turn sends information extracted from the forms to the IRS each week, starting in late March. IRC §§ 6051(a), 6049(a), 6042(a); see *IRS Instructions for Forms W-2 and W-3, Wage and Tax Statement and Transmittal of Wage and Tax Statements*; Social Security Administration, *Employer W-2 Filing Instructions & Information*, available at <http://www.ssa.gov/employer/gen.htm> (last visited Oct. 31, 2011).

<sup>24</sup> Per IRM 2.3.35.1.1 (May 3, 2010), TY 2011 data should be accessible online by May 11, 2012.

<sup>25</sup> See Most Serious Problem: *Reinstatement of a Modernized Telefile Would Reduce Taxpayer Burden and Benefit Tax Administration*, *infra*. However, we understand that the AMTAP currently does not have an automated way to utilize IRPTR information, so this matching must be conducted manually, further delaying the "verification" process.

<sup>26</sup> IRM 21.9.1.8(2) (Oct. 1, 2010).

If AMTAP cannot verify the information through internal records or by contacting the employer, the IRS sends the taxpayer a Letter 4115C with an “unable to verify” paragraph requesting documentation (e.g., pay stubs, Forms W-2), and extends the refund hold.<sup>27</sup> AMTAP will also extend the hold when information has not been verified and the temporary hold is expiring.<sup>28</sup>

**The IRS Should Use Hard Refund Freezes Only When There Is an Indication of Fraud, Not as an Inventory Management Tool.**

Given the importance of protecting taxpayers and the tax system from refund fraud and improper payments, the National Taxpayer Advocate believes that the IRS should have a reasonable amount of time in which to determine whether the refund claim bears the “badges of fraud” or is otherwise suspect, such that it should be held for further investigation or examination. As provided in the 2006 memorandum, the IRS and the National Taxpayer Advocate agreed that releasing refunds systemically within 70 calendar days of the initial refund freeze (then known as a “P-freeze”), unless it referred the case for criminal investigation (such cases received a “Z-freeze”), struck an appropriate balance between revenue protection and taxpayer burden.<sup>29</sup> As a consequence, CI issued guidance stating that a P-freeze “must be resolved within 70 calendar days; if not, the refund will be automatically released through master file programming.”<sup>30</sup>

With the Questionable Refund Program transferred from CI to W&I, the National Taxpayer Advocate is concerned that the IRS is moving away from its commitment to release refunds if it cannot determine in a reasonable time that a claim requires additional investigation. Current procedures advise IRS employees that “[i]t may be necessary to take additional actions to hold the refund after the 11 cycle freeze [77 days on top of the two-week re-sequencing] if a permanent freeze has not posted and the final return disposition still is uncertain.”<sup>31</sup>

**The IRS does not systemically release refunds within 70 days, harming taxpayers and violating the 2006 Memorandum of Understanding with the National Taxpayer Advocate.**

The current process of manually matching wage and withholding information is labor-intensive and further delays legitimate refund requests. While verifying wages and withholding is necessary to protect against improper claims, such delays can create real financial

<sup>27</sup> IRM 21.9.1.8.4(6) (Mar. 31, 2011); IRM 21.9.1.11.6 (Mar. 7, 2011). Letter 4115 requests income documentation from the taxpayer/employee (e.g., copies of checks, bank statements, pay statements, check stubs, and employer letters).

<sup>28</sup> Email from AMTAP analyst (Sept. 28, 2011).

<sup>29</sup> See Memorandum Regarding IRS Criminal Investigation Questionable Refund Program Procedures (Feb. 3, 2006); National Taxpayer Advocate 2006 Annual Report to Congress 412; IRS, *Fraud Detection Center - FDC Guidelines for Processing Year 2007 Issued by Refund Crimes and the Fraud Detection Centers* 17 (Dec. 2006).

<sup>30</sup> See IRS, *Fraud Detection Center - FDC Guidelines for Processing Year 2007 Issued by Refund Crimes and the Fraud Detection Centers* 17 (Dec. 2006).

<sup>31</sup> IRM 21.9.1.2.3(1), *Stopping the Refund* (Oct. 1, 2010). IRM 21.9.1.2.5 does instruct AMTAP employees to send the 4115 letter requesting additional information, but does not specify that this letter should be sent when the hard freeze is input on the account.

hardship for taxpayers awaiting legitimate refunds. Despite the significant challenges the IRS is facing, we believe that requiring honest taxpayers to wait more than ten weeks to receive their refunds — and often substantially more than ten weeks — imposes a heavy burden. Moreover, ten weeks should be enough time for the IRS to determine whether a refund claim is so questionable as to require a “hard freeze” or a referral to Examination personnel.

In practice, the IRS routinely extends refund freezes past 11 weeks by placing hard freezes on accounts. *The IRS has informed TAS that it applied a subsequent freeze to 414,000 taxpayer accounts in FY 2011.*<sup>32</sup> We are concerned that, instead of releasing refunds after 11 weeks when it cannot determine they warrant deeper scrutiny, AMTAP is placing hard freezes on the accounts simply because it could not verify wages and withholding within the established timeframe. In other words, AMTAP is using a hard freeze — normally designated for accounts in which potentially fraudulent activity has been “verified” — as an inventory management tool, without first having conducted sufficient analysis of relative risk.

*A TAS review of a representative sample of TAS pre-refund cases closed in FY 2011 shows that the taxpayers who received a hard refund freeze obtained relief 84 percent of the time.*<sup>33</sup>

In a review of TAS pre-refund cases closed in FY 2011, we found that the IRS had applied a “hard freeze” in at least 50 percent of cases reviewed.<sup>34</sup> In such cases, taxpayers obtained relief 84 percent of the time — with full relief in 81 percent of these cases.<sup>35</sup> The review confirmed that even in cases where the IRS applied a hard freeze to an account, the IRS ultimately agreed that approximately five out of every six taxpayers who received a hard refund freeze and came to TAS were eligible for relief (with four out of five taxpayers receiving full relief).<sup>36</sup> While the TAS study is not a representative sample of all AMTAP cases, it demonstrates that the IRS screens suffer from significant flaws that impose heavy burdens on legitimate taxpayers.

When a case has a temporary, expiring freeze code, IRS employees have an incentive to work the case within the agreed-upon timeframe. If a permanent, hard freeze replaces the soft freeze, this incentive no longer exists. With competing priorities, the temptation is to work current cases and let cases with a hard freeze languish. This is the same situation that prompted the National Taxpayer Advocate to highlight the problems in CI procedures in 2005 and 2006. Today, these problems still exist, except that they involve IRS employees on the civil side, rather than from CI.

<sup>32</sup> Email from AMTAP analyst (Oct. 4, 2011). AMTAP cannot determine how many of these related to known schemes or cases where it was unable to verify wages or withholding.

<sup>33</sup> See TAS Study.

<sup>34</sup> See *id.*

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

The IRS should not address its resource shortfall by using permanent refund freezes as an inventory management tool. Refunds should be held past the agreed-upon 11-week period only in limited circumstances (*e.g.*, where AMTAP has reason to believe the taxpayer was involved in a scheme based on a referral from CI or other law enforcement agencies). Absent exigent circumstances, the IRS should adhere to its commitment to systemically release frozen refunds if cannot determine within 70 days that the return is part of a scheme or merits more investigation. If this is not possible with the present staffing levels in AMTAP, then fairness and due process considerations require the IRS to increase the program's staffing, as well as to continually improve its filtering criteria.<sup>37</sup>

**AMTAP Selects More Returns than Ever, but Relies on Screens Based on Imperfect Data, Increasing the Risk of Taxpayer Harm.**

The IRS appears to be facing a growing influx of sophisticated criminal schemes designed to claim improper refunds. In response, the IRS is increasingly using external databases to identify and prevent refund fraud. For example, the IRS has identified a fraudulent refund scheme involving prisoner Social Security numbers (SSNs). The Earned Income Tax Credit (EITC) excludes from the definition of earned income any amount received for services provided by an inmate.<sup>38</sup> Despite this limitation, the IRS continues to receive refund claims originating from prisons, such as false EITC claims or overstated withholding.<sup>39</sup> To combat prisoner EITC schemes, the IRS uses state prison system records to systemically deny refund claims from inmates who have been incarcerated for the entire year.

The National Taxpayer Advocate is concerned that the IRS is relying on inaccurate state information to systemically deny such refund claims. The Treasury Inspector General for Tax Administration (TIGTA) noted in a December 2010 report that 12 percent of the data in the 2009 prisoner file contained inaccurate or missing information.<sup>40</sup> For example, the prisoner file may contain inaccurate SSNs, dates of birth, and release dates. If a release date is incorrect, the IRS may deny a refund to an ex-prisoner who is entitled to the refund because it accrued before incarceration or after release from prison. One possible result of

<sup>37</sup> The National Taxpayer Advocate recognizes that in the current budget environment, the IRS must make a choice between increasing AMTAP staffing and using its resources elsewhere in the agency. Ultimately, we encourage Congress to fund IRS adequately to both protect revenue and assist legitimate taxpayers in receiving their refunds timely. See Most Serious Problem: *The IRS Is Not Adequately Funded to Serve Taxpayers and Collect Taxes*, *supra*.

<sup>38</sup> IRC § 32(c)(2)(B)(iv). This includes amounts received for work performed while in a work release program or while in a halfway house.

<sup>39</sup> Not all prison schemes involve prisoners committing the fraudulent act. In some instances, the fraudulent schemes originate from prison employees who unlawfully obtain the names and SSNs of inmates to file falsified refund claims. See Department of Justice, *Plea Entered in Prison Tax Refund Ring* (June 14, 2007), available at [www.justice.gov/tax/usaopress/2007/txdv0720070614\\_Robinson\\_TpaTaxPlea.pdf](http://www.justice.gov/tax/usaopress/2007/txdv0720070614_Robinson_TpaTaxPlea.pdf).

<sup>40</sup> See TIGTA, Ref. No. 2011-40-009, *Significant Problems Still Exist with Internal Revenue Service Efforts to Identify Prisoner Tax Refund Fraud* 10 (Dec. 29, 2010).

the IRS's dependence on unreliable data as the basis of an adjustment is that the IRS may lose its presumption of correctness if a taxpayer challenges the assessment in court.<sup>41</sup>

In discussions with TAS, the IRS has recognized the need to validate the accuracy of such information obtained from third parties, but it has not articulated or committed to precisely how and when it will do the validation. If validation is not done before the 2012 filing season, the IRS will create unnecessary work for its already over-burdened program and inflict unnecessary harm on taxpayers.

The IRS has identified another scheme that has been dubbed "Operation Mass Mail." Tax returns identified as being part of this scheme are simply not processed (*i.e.*, they are "auto-voided," in IRS parlance). In CY 2011, AMTAP identified approximately 893,000 returns that fit OMM criteria.<sup>42</sup> When an impacted taxpayer calls the IRS to inquire about his or her refund, the customer service representative will instruct the taxpayer to re-submit the return, but will not advise the taxpayer of its "auto-void" status — which means that the tax return is put aside and not processed, and the taxpayer is never notified.<sup>43</sup> Thus, rather than engaging with the taxpayer and giving him or her an opportunity to correct or explain the questionable item, the IRS creates more work for itself by telling the taxpayer to re-submit the return. Moreover, because the IRS does not use the opportunity to obtain more information from the taxpayer, the re-submitted return may again be "auto-voided."

The IRS has no systemic filters that kick out OMM returns, relying instead on its employees' discretion in flagging these returns as being suspicious based upon a manual review. The rules used to identify an OMM return are sweeping in their reach and have the potential to ensnare many legitimate taxpayers.<sup>44</sup> The OMM program in CY 2011 potentially impacted over 34,000 innocent taxpayers (almost eight percent of the returns originally marked "OMM") who had no idea that their returns had been "auto-voided."<sup>45</sup> Some of these taxpayers came to TAS for help in obtaining their legitimate refunds. In the TAS study, 23 out of 373 cases (six percent) were identified as OMM cases.<sup>46</sup> Of these, TAS was able to obtain relief in 17 cases, or 74 percent of the time (with full relief in 16 cases,

<sup>41</sup> IRC § 6201(d) may require the IRS to prove that its determination is based on "reasonable and probative information" in any court proceeding regarding a deficiency based on an information return. IRC § 6201(d) was enacted following the IRS's loss in *Portillo v. Comm'r*, 932 F.2d 1128 (5th Cir. 1991) (described at IRM 4.10.4.6.1.3.2(2)), where it relied on information from a third party (Form 1099 from a customer of the taxpayer) to assert that the taxpayer underreported income. Although the IRS established that the taxpayer was a painter who engaged in painting during the period in question, the court held the IRS's statutory notice of deficiency was "arbitrary and erroneous" and not entitled to a "presumption of correctness" because the IRS failed to establish that the taxpayer received the unreported income shown on a Form 1099 after the taxpayer cooperated and raised reasonable concerns about its accuracy. For a more detailed discussion, see the introduction to the revenue protection MSPs, *supra*.

<sup>42</sup> AMTAP identified 893,267 OMM returns through October 15, 2011. Email AMTAP analyst (Nov. 4, 2011).

<sup>43</sup> See IRM 21.4.1.3.1.1 (Aug. 12, 2011).

<sup>44</sup> The National Taxpayer Advocate is not at liberty to disclose these OMM criteria, but has expressed her concern to the highest levels of the IRS about the sweep of these rules and their underlying assumptions.

<sup>45</sup> In CY 2011 (through September 30), AMTAP marked 429,108 taxpayer accounts with OMM. During this period, AMTAP marked 34,053 accounts with OMM GB, nearly eight percent of the total. An OMM GB marker means that after the IRS initially nullified a return as OMM, it later determined the return was from a legitimate taxpayer reporting the correct wages and withholding, and should have been processed. Privacy, Information Protection and Data Security (PIPDS) Incident Tracking Statistics Report (Sept. 30, 2011).

<sup>46</sup> See TAS Study.

70 percent of the time).<sup>47</sup> We are concerned that the broad and vague scope of the rules, coupled with inadequate training of employees, causes legitimate returns to be branded as OMM returns, with severe consequences to the taxpayers.

### **The IRS Does Not Notify Taxpayers When It “Auto-Voids” Certain Suspicious Refund Claims.**

Under the OMM “auto-void” procedures, the impacted taxpayer is given no notice and no opportunity to respond. This lack of communication was one of the main concerns raised in the National Taxpayer Advocate’s 2005 Annual Report to Congress, when CI was in charge of the QRP:

Because of the seriousness of fraud, the government generally affords taxpayers an extra measure of protection before making determinations. Indeed, the general rule that the taxpayer bears the burden of proof in tax liability disputes is reversed where the IRS asserts fraud; the government bears the burden of proving fraud in court. Yet despite the serious consequences of a finding of fraud, the IRS often freezes refunds without advising the taxpayer that it has made a determination of fraud, of the reasons for the determination, or of the consequences of that determination. Unless the taxpayer takes the affirmative step of contacting the IRS to inquire about his or her refund, the taxpayer may never know the IRS’s position with respect to that return.<sup>48</sup>

Six years later, the QRP has been passed on to W&I, but the concern regarding lack of taxpayer notification remains.

As the nation’s tax administrator, the IRS has an obligation to process all tax returns that meet the requirements of a timely filed return. However, under the OMM procedures, the IRS simply refuses to process a large subset of returns on the theory that a fraudulent return is a “nullity.” While non-processing of a “nullity” may be proper in limited circumstances where the IRS has actual evidence that an identity thief has filed a fictitious return, we do not believe that the IRS has the legal authority to determine that a tax return is a “nullity” based on a cursory screening, particularly in the OMM situation, where the screening rules are so broad and vague and where the IRS acknowledges it errs in tens of thousands of cases.

### **The IRS Does Not Have Sufficient Staffing or Systems Resources to Keep Up with Mounting AMTAP Inventory.**

While the number of returns selected for screening increased by 72 percent in 2011, AMTAP has not increased staffing accordingly.<sup>49</sup> AMTAP staffing in June 2011 was only

<sup>47</sup> See TAS Study.

<sup>48</sup> National Taxpayer Advocate 2005 Annual Report to Congress 27.

<sup>49</sup> The volume of returns selected to be screened rose from 611,845 in CY 2010 to 1,054,704 in CY 2011, a 72 percent increase. See W&I response to TAS information request (July 27, 2011, and updated Nov. 4, 2011).

about nine percent higher than in June 2010.<sup>50</sup> This disparity between workload and resources caused AMTAP's inventory level to rise to 690,000 cases at one point in FY 2011.<sup>51</sup> The hundreds of thousands of taxpayers caught up in the backlog may have to wait months for their refunds. This delay creates downstream work (such as the filing of duplicate returns and processing of additional correspondence) and forces the IRS to respond to a significant volume of additional calls from taxpayers inquiring about refunds.

With a significantly increasing volume of questionable refund claims coming in, EFDS is reviewing more returns than ever. EFDS, originally built in the 1990s, is nearing its maximum capacity. The IRS plans to replace EFDS with the Return Review Program (RRP) to alleviate this capacity concern. RRP is an integrated and unified system that will enhance the IRS's capabilities to prevent, detect, and resolve criminal and civil tax non-compliance. The IRS will begin phasing in RRP in 2013, but it may not be fully operational until 2014 or beyond.

### **The IRS Should Be Careful Not to Abridge Taxpayer Rights as It Proposes New Initiatives to Address Questionable Refunds.**

In FY 2011, IRS convened a team called the Accelerated Revenue Assurance Program (ARAP) to develop front-end verification procedures to prevent the payment of improper refund claims. For example, one of ARAP's proposals is for AMTAP to obtain access to the IRMF information earlier in the filing season, which may allow it to more easily "verify" a significant portion of its inventory.

The National Taxpayer Advocate is concerned that some ARAP proposals may infringe upon taxpayer rights. For example, ARAP has considered expanded use of the IRS's math error authority. Math error authority can be an effective processing tool in limited circumstances,<sup>52</sup> but it is only appropriate when errors are apparent on the face of a return or from information provided on a return. ARAP proposes that the IRS expand its use of math error authority to more complicated and facts-and-circumstances-based provisions. TAS has identified several proposals (*e.g.*, involving the adoption credit, education credits, and residential energy credit) whereby legitimately qualifying taxpayers could erroneously be issued a math error notice.

ARAP has also discussed using an automated process (called Automated Questionable Credits, or AQC) to deny certain below-tolerance refund claims. TAS raised several concerns about the AQC process. First, we noted the disparate treatment of low income taxpayers, who could be subject to multiple reviews or examinations of the same tax return,

<sup>50</sup> AMTAP staff increased from 336 in FY 2010 to 366 in FY 2011, an increase of 8.9 percent. See W&I response to TAS information request (July 27, 2011).

<sup>51</sup> IRS Decedent Schemes Conference Call (Apr. 21, 2011). AMTAP inventory not only includes cases requiring manual verification, but also decedent scheme identity theft cases and OMM cases.

<sup>52</sup> See Most Serious Problem: *Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights*, *infra*. The early legislative history of math error clearly shows that the deviation from deficiency procedures was to be limited in scope. See Legislative Recommendation: *Mandate that the IRS, in Conjunction with the National Taxpayer Advocate, Review Any Proposed Expanded Math Error Authority to Protect Taxpayer Rights*, *infra*.

while higher-income taxpayers and businesses would not. We also expressed concerns about the ambiguous language in the letter to taxpayers subject to the AQC process. Over the National Taxpayer Advocate's objections, for example, the letter to taxpayers in the AQC pilot did not include the word "audit" or "examination" even though there are dire consequences for not responding to this ambiguous letter and we believe the vague wording obscures those consequences.

As the IRS is exploring the use of systemic tools and processes to reduce AMTAP's workload, it is important that the IRS thoroughly analyze the legal and policy ramifications of each proposal. The IRS should first determine the specific legal basis for the changes, determine what notices are required by law (*e.g.*, Notice of Claim Disallowance or Statutory Notice of Deficiency), and examine whether taxpayers have an adequate opportunity to challenge the IRS's determination. The IRS should not let bad facts (*e.g.*, the influx of new schemes) dictate bad policy (*e.g.*, ignoring the requirements for taxpayer notice or simply refusing to process tax returns it suspects of being fraudulent).

#### **Taxpayers Coming to TAS with Pre-Refund Wage Verification Problems Obtained Relief at Least 75 Percent of the Time.**

Despite the significant increase in cases selected for review, EFDS purports to have a fairly high reliability rate. The IRS asserts that approximately 89 percent of the returns selected in 2011 (through October 15) as questionable have been "verified bad" — an upward trend from 68 percent "verified bad" in 2009 and 85 percent in 2010.<sup>53</sup> The National Taxpayer Advocate questions what the IRS means by "verified bad," because a TAS review of its AMTAP-related cases showed surprising results.

In the TAS study, 75 percent of the taxpayers who came to TAS with AMTAP-related issues obtained relief. This finding was corroborated when we analyzed data from every closed TAS case in FY 2011 with a Primary Issue Code 045 (Pre-Refund Wage Verification) or PIC 425 (Stolen Identity) with a Secondary Issue Code 045 — over 20,000 cases.<sup>54</sup> According to this analysis, taxpayers obtained relief from the IRS in 79.8 percent of these cases, with taxpayers receiving full relief 72.3 percent of the time.

Note that when taxpayers come to TAS for assistance, TAS generally must obtain the concurrence of the IRS function "owning" the case in order to obtain relief for the taxpayer. This is true for AMTAP cases in TAS (*i.e.*, AMTAP must agree that the taxpayers are entitled to relief). The most common reason cases closed with no relief was that the taxpayer did not respond to requests for supporting documentation that would have allowed release of the stopped refund, as shown in the table below.

<sup>53</sup> See W&I response to TAS information request (July 27, 2011, and updated Nov. 4, 2011).

<sup>54</sup> TAMIS/Business Objects (BOBJ) Report, FY 2011 Closures. All TAS cases are assigned a Primary Issue Code, and many TAS cases are also assigned a Secondary Issue Code.

**TABLE 1.2.1, Issue Code 045 Closures by Relief Code, FY 2011<sup>55</sup>**

| Cases with Relief                         | # of Cases Closed | # of Cases Closed |
|---|-------------------|-------------------|
| Taxpayer Assistance Orders (TAOs)         | 72                | 0.3%              |
| Full Relief                               | 14,917            | 72.3%             |
| Partial Relief                            | 332               | 1.6%              |
| Assistance                                | 315               | 1.5%              |
| OD Function Provided Relief               | 823               | 4.0%              |
| Cases with No Relief                      | # of Cases Closed | # of Cases Closed |
| No Relief - Law Prevents                  | 15                | 0.1%              |
| No Relief - Hardship Not Substantiated    | 16                | 0.1%              |
| No Relief - No Response                   | 3,620             | 17.6%             |
| No Relief - TP Withdrew Request           | 149               | 0.7%              |
| No Relief - No Internal Revenue Law Issue | 15                | 0.1%              |
| No Relief - Other                         | 349               | 1.7%              |
| Total Closures                            | 20,623            |                   |
| Relief Rate                               |                   | 79.8%             |

These results raise the question of why a group of taxpayers who eventually obtained full relief (*i.e.*, received their full refunds) at such a high rate was pulled into the EFDS filters, which purportedly generate “verified bad” returns 89 percent of the time.<sup>56</sup>

We recognize that the taxpayers coming to TAS may not be representative of the general taxpayer population and we cannot extrapolate the 75 percent relief figure from the TAS study across AMTAP’s entire inventory (which includes cases related to identity theft and other schemes). However, the TAS data clearly demonstrate significant limitations inherent in the IRS verification process and its assumptions. In these cases, the IRS should be asking: what initially triggered the EFDS filters and what steps did TAS have to take to advocate and provide relief for the taxpayers? For example, did TAS case advocates follow up with taxpayers by phone multiple times? If so, would it make sense for AMTAP employees to follow up with a phone call to taxpayers who do not immediately respond to the Letter 4115 requesting documentation of wages or withholding?

EFDS selected approximately one million returns for screening in 2011.<sup>57</sup> By the IRS’s own estimation, it was unable to “verify bad” 11 percent of these returns, leaving up to 116,000 potentially “good” taxpayers improperly caught up in the EFDS filter.<sup>58</sup> Of the approximately 20,600 pre-refund cases TAS closed in FY 2011, more than 16,000 (79.8 percent) obtained relief. So by comparing these two numbers, it is reasonable to conclude

<sup>55</sup> This chart includes PIC 045 cases, plus PIC 425 cases with SIC 045, closed in FY 2011. TAMIS/BOBJ Report, FY 2011 Closures.

<sup>56</sup> See W&I response to TAS information request (July 27, 2011, and updated Nov. 4, 2011).

<sup>57</sup> The volume of returns selected to be screened was 1,054,704 in CY 2011 (through Oct. 15, 2011). See W&I response to TAS information request (Nov. 4, 2011).

<sup>58</sup> Inability to “verify bad” could result from a variety of reasons; it does not necessarily indicate that such a tax return is legitimate or submitted by the person who owns the Social Security number.

that potentially 100,000 innocent taxpayers who did not come to TAS were harmed by the EFDS filter in 2011.<sup>59</sup> Some probably worked directly with the IRS to obtain relief, and others were probably too intimidated, perplexed, or otherwise unable to respond, with the result that they will not receive their refunds.

The National Taxpayer Advocate raised this concern in her 2005 Annual Report to Congress: “CI’s fraud detection methods are not as effective as they should be at screening out non-fraudulent refund claims, and therefore cause undue burden for a significant number of taxpayers.”<sup>60</sup> In its written response, the IRS touted the “efficiency” of EFDS at stopping refunds.<sup>61</sup> We now have evidence that there is significant collateral damage caused by AMTAP pulling in so many legitimate taxpayers. Tens if not hundreds of thousands of taxpayers entitled to refunds are getting caught up in anti-fraud procedures that, at best, require them to devote time and effort to substantiating their claims and, at worst, block them from ever receiving their legitimate refunds.

## CONCLUSION

The IRS must deal with the challenging combination of increasing opportunities for refund fraud and decreasing resources to combat such activities. The National Taxpayer Advocate recognizes the need for automated screening mechanisms to alleviate the burden of manual reviews. However, systemic screens are inherently imperfect – they will be both underinclusive and overinclusive. It is therefore critical that the IRS develop a mitigation strategy to ensure it can promptly and accurately resolve the problems of legitimate taxpayers who get caught up in the filters.

It is easy to paint all taxpayers who are ensnared by systemic filters with a broad brush, but experience tells us that even where the IRS believes it has verified that a return is false or fraudulent, it is sometimes wrong. To minimize the harm to innocent taxpayers, the IRS must give taxpayers adequate notice of its findings and an adequate opportunity to respond.

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

1. Provide the AMTAP unit sufficient staff and systems resources to work its inventory timely.
2. Make Information Returns Master File data available sooner in the filing season.
3. Adhere to the policy of systemically releasing refunds after 70 days if the IRS cannot determine that the return is part of a known scheme or requires greater scrutiny.

<sup>59</sup> 116,017 (potentially “good” taxpayers caught up in EFDS) less 11,743 (that obtained relief after coming to TAS) leaves 104,274 “good” taxpayers who were caught up in the EFDS screen in 2011. See W&I response to TAS information request (Nov. 4, 2011). This is a conservative estimate, as we know from our study that some percentage of the taxpayers that receive a hard freeze (purportedly because they are deemed “verified bad”) ultimately prevail and receive their refunds. In the TAS study, 84 percent of such taxpayers received relief (81 percent receiving full relief).

<sup>60</sup> National Taxpayer Advocate 2005 Annual Report to Congress 29.

<sup>61</sup> See *id.* at 46.

4. When considering implementation of any front-end verification procedures, concurrently develop procedures to promptly assist taxpayers who demonstrate that they have filed legitimate refund claims.
5. When considering alternative treatment streams, conduct a thorough analysis to determine the specific legal basis for the proposed action (or non-action).
6. Before "auto-voiding" any tax returns, notify the impacted taxpayers and allow them an opportunity to correct or explain the questionable items.
7. Include language in the Automated Questionable Credits notice alerting taxpayers that the tax return is being examined or that they are under audit, and make clearer that there are significant legal consequences for failing to respond to the notice by the deadline.

### IRS COMMENTS

The Taxpayer Assurance Program, known as AMTAP, recently completed its second filing season. AMTAP screened and verified almost two million cases in FY 2011, stopping over \$14 billion in false refunds. In FY 2010, AMTAP screened and verified over 800,000 cases, stopping over \$5 billion in false refunds. This 2011 activity represents a 142 percent increase in cases worked and a 162 percent increase in revenue protected over 2010 results.<sup>62</sup>

The IRS must continually balance the rights of taxpayers with our responsibility to protect the interests of the United States and the majority of taxpayers who accurately file and pay their federal taxes. The voluntary compliance design of America's tax system requires the IRS to take efforts to support compliant taxpayers by detecting fraud and errors of those looking to be noncompliant. It is a continuous challenge to quickly identify perpetrators and individuals who use sophisticated methods to defraud the nation's tax system. This detection can be more time-consuming when individuals are not associated with a known scheme, and cases require analysis, third party information, and actions to assure that legitimate taxpayers are protected.

Those looking to defraud the government have become more brazen and are availing themselves to a variety of resources both outside and within the system to try to force the release of false refunds. In some cases, this even includes calling Taxpayer Assistance toll-free telephone numbers or seeking support through the Taxpayer Advocate Service. A current example involves over 200 filings that IRS deemed fraudulent with associated revenue protected of more than \$800,000. Thirty of those false returns had an open TAS case; meaning that perpetrators have contacted the IRS through TAS to try to force the release of the associated refunds. As another example, Operation Mass Mail is a scheme where perpetrators contact toll-free assistors and TAS to force refund release. In dealing with these situations, the IRS follows established taxpayer support requirements which require use of

<sup>62</sup> AMTAP from the EFDS.

valuable resources to ensure that the fraud determination is correct. These two examples are just a snapshot of the challenges to the IRS in maintaining a balance between revenue protection, providing valid taxpayer support and minimizing taxpayer burden.

As those attempting to commit refund fraud become more sophisticated, the IRS must take steps to respond accordingly. The IRS continues to recognize the importance of taxpayer rights, but we must ensure that processes are in place to effectively stop refund fraud. We have made recent improvements in this regard. The IRS launched two high impact initiatives in May 2011 to identify improvements to better combat fraud, identity theft, and revenue and taxpayer protection. The Accelerated Refund Assurance Program was a servicewide initiative working internally and externally with IRS partners, stakeholders, agencies and departments at the local, state, national and international level to preserve the integrity of America's tax system. The National Taxpayer Advocate participated in this initiative, and provided representatives for our ARAP teams. The IRS is deploying a number of improvements from the ARAP initiative for filing season 2012 and beyond, such as accelerating availability of wage and withholding documents by eight weeks, and launching systemic tools to perform income verification.

An additional effort is the formation of Return Integrity and Correspondence Services, creating a centralized organization for ensuring revenue protection and refund compliance. AMTAP was realigned to this new RICS office October 2011. The new RICS office has quickly moved to balance the taxpayer experience, revenue protection and resource efficiency. During filing season 2011, RICS extended AMTAP seasonal employees to better address inventory needs. For filing season 2012, RICS increased AMTAP staffing significantly, and is training all AMTAP permanent employees on account work to dedicate more higher skilled employees to successfully tackle the complex challenges of refund fraud and identity theft work. To further protect taxpayers and their refunds, the RICS organization is finalizing plans to deploy a specialized identity theft unit in FY 2012.

We respectfully disagree with the National Taxpayer Advocate's conclusions from the TAS study referenced in the report – we believe that it creates an inaccurate perception that all AMTAP cases average a delay of 25 weeks. We believe that the TAS study is not a representative sample of AMTAP cases. We also disagree with the inference that IRS employees have no incentive to work cases that have an extension of a freeze code. IRS employees take seriously their responsibility to accurately assist taxpayers – freezes on accounts do not affect their commitment to taxpayers.

With respect to the specific recommendations in the draft report, the IRS notes the following.

As discussed, the IRS has taken steps to provide the AMTAP unit staff and systems resources to work its inventory timely. We increased our AMTAP staff this filing season and will continue to monitor whether additional resources are necessary (if available). We will also assess the efficiencies gained from the accelerated availability of the Information

Returns data to determine appropriate resources utilization and allocation to best address our inventory.

With respect to the recommendation to make data available sooner in the filing season, in 2009 AMTAP recognized accessing Information Returns Master File (IRP) data earlier in the filing season would allow for faster verification; thus releasing legitimate claims sooner. An ARAP team worked with Modernization and Information Technology Services and IRP to accelerate availability of W-2 data in filing season in order to allow earlier identification of mismatches. We will continue to pursue additional opportunities to shorten that timeframe in filing season 2013.

With respect to the recommendation to release refunds after 70 days, the IRS believes that given the current environment, the IRS must maintain the right to determine when it is inappropriate to release refunds if questions as to legitimacy exist. The IRS developed revenue protection processes over many years using historical data to determine fraud indicia. The IRS refines fraud models each year based on performance and new characteristics and updates procedures for reviewing and processing revenue protection inventory accordingly to ensure indication of fraud before holding a refund. Manual screening processes also ensure that a return meets established fraud characteristics before designation for verification and refund hold. Due to the historical evidence of known fraud, the explosion in fraud and identity theft in the past two years, and the consistent amount of revenue protected by IRS fraud detection efforts developed from this analysis, IRS must maintain the right to determine when a hard refund freeze is appropriate.

Regarding changes to processes, the IRS balances taxpayer rights with the need to stop refund fraud. As we move forward, we will continue to explore opportunities for expeditious treatment and assistance for taxpayers with legitimate refund claims in all stages of design, development, testing and deploying of any new technology, process and procedures. When considering alternative treatment streams, as with our past practices, AMTAP will continue to request specific legal guidance about proposed alternatives.

The IRS will consider the views in the draft report regarding notifying impacted taxpayers before auto-voiding tax returns. The IRS is mindful of taxpayer rights and only uses this policy where we believe appropriate. The IRS developed the policy to "auto-void" returns to address schemes identified based on historical analysis of repeated fraud characteristics. For example, the Operation Mass Mail scheme is a very high volume scheme attempted annually. Part of the scheming effort is to inundate IRS with returns to force release of some of the refunds. In these cases, attempting to correspond on these fraud returns would be an ineffective use of resources and taxpayer dollars. These returns often do not include a valid address. In addition, in some cases, corresponding provides fraudsters with additional or new avenues to try to force refund release.

Finally, with respect to the recommendation to include audit or examination language in the Automated Questionable Credits notice, we have determined that under Revenue Procedure 2005-23 Automated Questionable Credits are not considered audits.

The IRS will continue to work with the National Taxpayer Advocate as we make improvements in detecting and stopping refund fraud while recognizing the rights of legitimate taxpayers.

### Taxpayer Advocate Service Comments

The National Taxpayer Advocate recognizes the difficult position the IRS is in as the gatekeeper to the public fisc and applauds its efforts to flag suspicious refund claims. The National Taxpayer Advocate supports the use of front-end screening where appropriate, but firmly believes that an *expedited* mitigation strategy must be part of any such process.

When the IRS selects a return for manual verification or otherwise delays a refund, it should notify the taxpayer and allow him or her the opportunity to respond. Knowing that a significant percentage of legitimate taxpayers will be caught up in the automated filters, it is imperative for the IRS to conclude its verification process or release refunds in a reasonable time. The National Taxpayer Advocate continues to believe 70 days (plus the 14 days used for initial selection) is reasonable, as agreed to in 2006 by CI, SB/SE, W&I, and TAS. This time limitation does not in any way impact the IRS's "right to determine when a hard refund freeze is appropriate." Instead, the time limitation ensures that the IRS makes that determination — whether to issue a hard freeze or release the refund — within a reasonable period of time. This is the least that the IRS can do as a mitigation strategy for legitimate taxpayers who will inevitably be caught up in IRS filters.

The National Taxpayer Advocate understands the difficulty of staffing AMTAP to accommodate the increasing volume of questionable refund claims. Particularly when manual verification is required, it will be challenging for AMTAP to meet the 70-day timeframe without a corresponding increase in personnel. The new RICS organization must closely monitor AMTAP's workload and adjust staffing as necessary to keep up with inventory. Ultimately, Congress will need to make funding decisions that would enable the IRS to adequately staff AMTAP.<sup>63</sup>

We studied a statistically representative sample of pre-refund wage verification cases TAS closed in FY 2011 in an effort to better understand the reasons for the significant increase in these TAS cases. We found the IRS had placed a hard freeze on the taxpayer's account in at least 50 percent of the cases in this sample, with taxpayers eventually obtaining relief

<sup>63</sup> See Most Serious Problem: *The IRS Is Not Adequately Funded to Serve Taxpayers and Collect Taxes*, *supra*.

84 percent of the time.<sup>64</sup> The average refund amount was over \$5,600 (the median was approximately \$4,100), and the average delay was 25 weeks (with a median delay of slightly under 19 weeks).<sup>65</sup> While these taxpayers may not be representative of the general taxpayer population, the TAS data clearly demonstrate significant limitations inherent in the IRS verification process and its assumptions. The findings of the TAS study support the need for the IRS to develop an effective mitigation strategy to assist the legitimate taxpayers who will inevitably become caught up in even the best of filters.

The IRS states that some persons who submitted fraudulent returns have come to TAS for assistance, implying a misuse of TAS resources. To support this statement, the IRS refers to a study and 30 cases. We note that the IRS has neither cited a source for this study nor shared with TAS information about those 30 cases, so we do not know the ultimate outcomes. As far as we know, this could be just another instance of the IRS “deeming” fraud but ultimately agreeing that the taxpayer is entitled to relief once it actually looks at the facts of the case.<sup>66</sup>

To eliminate any confusion, the National Taxpayer Advocate would like to point out that TAS does not make substantive decisions in any case. For example, the 84 percent relief rate in the TAS study was a result of advocacy on the part of TAS case advocates, but ultimately it was the IRS that determined the taxpayers were entitled to relief.

In addition, for the 16 percent of taxpayers that did not obtain relief in the TAS study, there is still value in the process. One of TAS's quality measures is to educate the taxpayer. By informing taxpayers about why they were not entitled to relief, we educate them on tax law and procedure and seek to foster improved compliance in the future.

<sup>64</sup> See TAS Study. Hard freezes were almost certainly applied in additional cases. In some instances, the IRS may apply a hard freeze by inputting a second TC 570. Because the master file does not capture when a second TC 570 is input, TAS included in its count of hard freezes only cases that contained RCC 3 and TC 841 codes in the 373-case sample.

<sup>65</sup> See *id.*

<sup>66</sup> Historically, it is true that a very small number of taxpayers with clearly improper claims approach TAS for assistance each year. When that happens, TAS generally identifies the improper claim or the IRS identifies it when TAS consults with the IRS on the case. Both in absolute and relative terms, however, the number of taxpayers who are brazen enough to attempt to use TAS to further fraudulent activity is infinitesimal. Moreover, the extent of the problem should not be overstated for several reasons. First, it could cause taxpayers with bona fide problems to refrain from seeking TAS assistance out of concern they may be viewed as potential perpetrators of fraud. Second, it could encourage perpetrators of fraud to seek TAS assistance. Third, it could cause case advocates to treat all taxpayers with great skepticism. For the context, the TAS historically has obtained full relief approaching 70 percent of taxpayers who seek our assistance (and partial relief for another three to five percent of taxpayers). In the remaining cases, the taxpayer typically believed he or she was entitled to assistance, and the experience has enabled TAS to educate the taxpayer about the law, which should improve future compliance.

## Recommendations

The National Taxpayer Advocate recommends that the IRS:

1. Provide the AMTAP unit sufficient personnel and systems to work its inventory timely.
2. Continue working to accelerate the availability of Information Returns Master File data to identify mismatches earlier in the filing season.
3. Adhere to the policy of systemically releasing refunds after 70 days if the IRS cannot determine that the return is part of a known scheme or requires greater scrutiny.
4. When considering implementation of any front-end verification procedures, concurrently develop procedures to promptly assist taxpayers who demonstrate they have filed legitimate refund claims.
5. When considering alternative treatment streams, conduct a thorough analysis to determine the specific legal basis for the proposed action (or non-action).
6. Before “auto-voiding” any tax returns, notify the taxpayers and allow them an opportunity to correct or explain the questionable items.
7. Include language in the Automated Questionable Credits notice making clearer to taxpayers the significant legal consequences for failing to respond to the notice by the deadline.

MSP  
#3**Tax-Related Identity Theft Continues to Impose Significant Burdens on Taxpayers and the IRS****RESPONSIBLE OFFICIALS**

Beth Tucker, Deputy Commissioner for Operations Support

Richard E. Byrd Jr., Commissioner, Wage and Investment Division

**DEFINITION OF PROBLEM**

Tax-related identity theft is a rapidly growing crime that often imposes enormous financial, emotional, and time-consuming burdens on its victims. It may take many forms, including the following:

- An identity thief files a false return early in the filing season that claims a refund and uses a victim's Social Security number (SSN). When the victim later tries to e-file her own return, it is blocked.<sup>1</sup> About 83 percent of all tax returns result in refunds, with the average amount over \$3,000.<sup>2</sup> For many taxpayers, a significant delay in receiving a refund of this magnitude can impose financial hardship. Moreover, the victim may have to devote significant time and effort to proving to the IRS that she is the "real" taxpayer.
- An identity thief files a false return that claims a refund and uses the SSN of a disabled person in an assisted living facility. The false return shows fake self-employment (Schedule C and Schedule SE) income and refundable credits, resulting in a refund. The IRS reports the self-employment income to the Social Security Administration (SSA), which terminates the victim's Social Security benefits, potentially causing the facility to discharge the patient.
- An identity thief obtains data from the Social Security Death Master File via the Internet to find the names, SSNs, birth dates, and locations of recently deceased minor children and then claims them as dependents on a false tax return. When the parents subsequently try to electronically file a return claiming their child as a dependent during the year in which he or she died, they are unable to do so because the child was previously claimed by the identity thief. Instead, the grieving parents must file a paper return.

In recent years, the Taxpayer Advocate Service (TAS) has worked closely with the IRS to improve servicewide efforts to assist identity theft victims. Over the last few years, the IRS has made significant progress in this area and has adopted many of our recommendations, including the establishment of a dedicated unit to help the victims.

<sup>1</sup> See Internal Revenue Manual (IRM) 21.3.4.32.1 (Nov. 8, 2010).

<sup>2</sup> The average fiscal year (FY) 2010 refund amount was \$3,048. FY 2010 IRS Data Book, table 8, footnote 3. The percent of returns with refunds is 82.9 percent (119.4 million refunds out of 144.1 million total individual tax returns). FY 2010 IRS Data Book, tables 2 and 7.

However, the crime of tax-related identity theft continues to grow, and notwithstanding the IRS's efforts, its resources and ability to resolve cases are stretched thin. In fiscal year (FY) 2011, the centralized Identity Protection Specialized Unit (IPSU) received more than 226,000 cases, a 20 percent increase over FY 2010.<sup>3</sup> Despite the establishment of the IPSU, TAS received over 34,000 identity theft cases in FY 2011, a 97-percent increase over FY 2010.<sup>4</sup> In reaction to this growing workload, the IRS is taking steps that may ensnare legitimate taxpayers without creating a pathway to quick resolution of their cases.

An IRS task force found that 28 different units within the IRS are involved in helping victims and discovered over 50 gaps in IRS procedures.<sup>5</sup> Among other deficiencies, the IRS does not have a mechanism to monitor how long it takes to resolve an identity theft case.<sup>6</sup> The task force recommended that the IRS adopt a specialized model for identity theft victim assistance and issue a personal identification number (PIN) to victims to use when filing returns so the IRS can properly distinguish the true taxpayer from the identity thief.

Even with a more specialized approach to victim assistance, the IRS will still require a “traffic cop” to ensure that the proper function handles each case in an acceptable timeframe. The IPSU has already been serving in this capacity for three years and should remain the single point of contact for taxpayers. In our view, however, this “traffic cop” needs greater authority. Although IPSU requests are supposed to receive priority treatment from other IRS organizations, some IPSU cases are not considered “aged” until after 180 days have passed.<sup>7</sup> Moreover, the IPSU has no way to ensure that the other functions adhere to the requested timeframes. Not surprisingly, identity theft cases controlled by the IPSU may languish for months.

The National Taxpayer Advocate has identified the following additional problems related to IRS handling of identity theft issues:

- The federal government facilitates tax-related identity theft by publicly releasing considerable personal information about recently deceased individuals, including a decedent's full name; SSN; date of birth; date of death; and the county, state, and zip code of the last address on record.
- When the IRS implements new filters to catch potentially fraudulent tax returns in identity theft cases, it does not always have effective strategies and sufficient resources

<sup>3</sup> IRS, *IPSU Identity Theft Report* (Oct. 1, 2011); IRS, *IPSU Identity Theft Report* (Oct. 2, 2010); IRS, *IPSU Identity Theft Report* (Oct. 3, 2009). This inventory includes all identity theft cases controlled by the IPSU paper unit, including self-reported non-tax-related identity theft cases, cases the IPSU monitors, and cases undergoing global account review. It does not include 26,695 cases that meet TAS's “systemic burden” case criteria, which the IPSU tracks separately.

<sup>4</sup> In FY 2010, TAS opened 17,291 stolen identity (primary issue code 425) cases. In FY 2011, the number jumped to 34,006. Taxpayer Advocate Management Information System (TAMIS), FY 2010, FY 2011 (Oct. 31, 2011).

<sup>5</sup> IRS, Identity Theft Executive Steering Committee, *Identity Theft Program Enhancements, Challenges and Next Steps* 14 (Oct. 19, 2011).

<sup>6</sup> TAS had an average cycle time of 107 days for identity theft cases, which sometimes involves multiple issues or multiple years, closed in FY 2011. TAS, Business Performance Management System.

<sup>7</sup> IRM 21.9.2.1(6) (Oct. 1, 2011).

to adequately assist honest taxpayers whose returns and refund claims are held up by the filters in error.

- The IRS is not adequately protecting identity theft victims by quickly acting upon referrals of identity theft schemes from its Criminal Investigation (CI) division and other sources.
- The IRS has not developed consistent guidance for its employees to promptly remove fraudulent income and credits related to substantiated identity theft from the victims' accounts.
- The IRS is not fully utilizing its existing authority to share information about identity theft schemes and the impact on the victims with the heads of other federal agencies.
- Because TAS employees have the unique perspective of working identity theft cases from start to finish, the IRS should include TAS in all levels of identity theft program and procedural planning. This should include front-line teams, training development, guidance, and advisory and executive steering committees.

## ANALYSIS OF PROBLEM

### Background

In general, identity theft occurs in tax administration in two ways — when an individual intentionally uses the SSN of another person to (1) file a false tax return with the intention of obtaining an unauthorized refund or (2) gain employment under false pretenses. In both situations, the victim is often sent on a journey through IRS processes and procedures that may take years to complete.

### The IRS Has Improved Its Processes for Assisting Identity Theft Victims.

The National Taxpayer Advocate has discussed the problem of tax-related identity theft for over seven years in her Annual Reports to Congress and congressional testimony.<sup>8</sup> The IRS has accepted many of TAS's recommendations for improving identity theft procedures. At various times, we have advocated for the following improvements, each of which the IRS has adopted in some form:

- Allowing employees greater discretion to determine the true owner of an SSN in question without referring the matter to the SSA;

<sup>8</sup> See National Taxpayer Advocate 2009 Annual Report to Congress 307-317; National Taxpayer Advocate 2008 Annual Report to Congress 79-94; National Taxpayer Advocate 2007 Annual Report to Congress 96-115; National Taxpayer Advocate 2005 Annual Report to Congress 180-191; National Taxpayer Advocate 2004 Annual Report to Congress 133-136; *The Spread of Tax Fraud by Identity Theft: A Threat to Taxpayers, a Drain on the Public Treasury*, Hearing Before the S. Comm. on Finance, Subcommittee on Fiscal Responsibility and Economic Growth, 112th Cong. (May 25, 2011) (statement of Nina E. Olson, National Taxpayer Advocate); *Filing Season Update: Current IRS Issues*, Hearing Before the S. Comm. on Finance, 111th Cong. (Apr. 15, 2010) (statement of Nina E. Olson, National Taxpayer Advocate); *Identity Theft: Who's Got Your Number*, Hearing Before the S. Comm. on Finance, 110th Cong. (Apr. 10, 2008) (statement of Nina E. Olson, National Taxpayer Advocate).

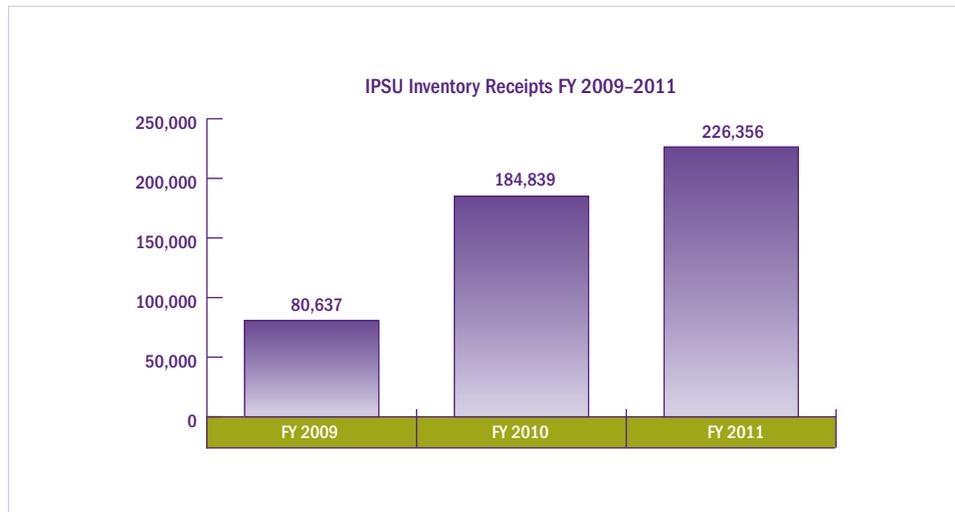
- Developing an electronic indicator to mark the tax accounts of verified victims;<sup>9</sup>
- Creating an IRS identity theft affidavit form;
- Adopting a standardized list of acceptable documents to substantiate identity theft;
- Establishing a centralized unit to help identity theft victims;
- Providing for a global account review prior to closing an identity theft victim's case to ensure that all related issues have been resolved; and
- Issuing a PIN to verified victims of identity theft to enable them to file returns electronically and prevent others from filing under the victims' SSNs.

Without doubt, the IRS is in a better position to help identity theft victims today than when the National Taxpayer Advocate first identified identity theft as a Most Serious Problem facing taxpayers in her 2005 Annual Report. But despite the improvements that have taken place in the last few years, the IRS continues to struggle with identity theft and cannot proactively safeguard taxpayer accounts from this crime.

**Despite Major Improvements, the IRS Is Receiving Unprecedented Volumes of Identity Theft Casework.**

The IRS established the IPSU in 2008 because it wanted to have a centralized unit that would accept identity theft cases and, if necessary, monitor actions taken by the various functions. This centralized unit is receiving an unprecedented volume of cases. As the chart below shows, IPSU receipts in FY 2011 increased substantially over the two previous years. This inventory does not include the tens of thousands of potential victims linked to various ongoing investigations of organized identity theft operations.

<sup>9</sup> Since the IRS started using an electronic indicator in 2009 to flag an account as being potentially compromised, it has tracked over 1.8 million incidents impacting over 1.1 million taxpayers. See IRS Office of Privacy, Information Protection, and Data Security (PIPDS) Incident Tracking Statistics Reports for calendar years ending 2009 and 2010 and for the period of January 1, 2011, through September 30, 2011.

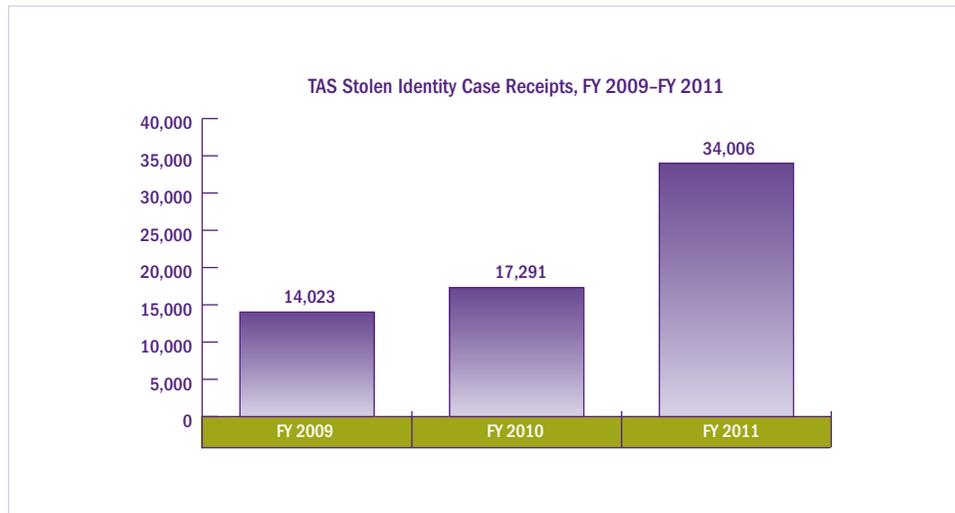
**FIGURE 1.3.1, IPSU Inventory Receipts, FY 2009 to FY 2011<sup>10</sup>**

TAS casework reflects the impact of the IRS's inability to promptly address identity theft victims' tax issues. TAS received 34,006 stolen identity cases in FY 2011, compared to 17,291 in FY 2010 and 14,023 in FY 2009.<sup>11</sup> This translates to a 97 percent increase in identity theft receipts in FY 2011 over FY 2010, on top of a 23 percent gain from FY 2009 to FY 2010. Moreover, this increase does not include 26,695 cases that meet TAS's "systemic burden" case criteria and were referred to the IPSU for processing under the March 2010 Memorandum of Understanding between TAS and the Wage and Investment (W&I) division.<sup>12</sup>

<sup>10</sup> IRS, *IPSU Identity Theft Report* (Oct. 1, 2011); IRS, *IPSU Identity Theft Report* (Oct. 2, 2010); IRS, *IPSU Identity Theft Report* (Oct. 3, 2009). This inventory includes all identity theft cases controlled by the IPSU paper unit, including self-reported non-tax-related identity theft cases, cases the IPSU monitors, and cases undergoing global account review. It does not include cases that meet TAS's "systemic burden" case criteria, which the IPSU tracks separately.

<sup>11</sup> TAMIS, FY 2009, FY 2010, FY 2011 (Oct. 31, 2011).

<sup>12</sup> IRS, *IPSU Identity Theft Report* (Oct. 1, 2011). See *Memorandum of Understanding Between the National Taxpayer Advocate and the Commissioner, Wage & Investment to Transition TAS Criteria 5-7 Identity Theft Cases to Wage & Investment Identity Protection Specialized Unit (IPSU)* (Mar. 31, 2010).

**FIGURE 1.3.2, TAS Stolen Identity Case Receipts, FY 2009 to FY 2011<sup>13</sup>****There Are Multiple Explanations for the Increase in Identity Theft Cases.*****Identity Thieves Have Become More Proficient.***

Over the years, those who commit identity theft have become more adept at devising schemes to steal identities. Increasingly, these schemes target taxpayers who are not required to file returns, such as the elderly, disabled, and children. As a result, it may take years for a victim to find out that an identity thief has stolen his or her SSN. One of the more sinister schemes involves the misuse of a deceased taxpayer's SSN to obtain fraudulent refunds. Perpetrators have gone as far as using the SSNs of deceased children, leaving their grieving parents to deal with the aftermath of the identity theft.<sup>14</sup>

***Tax-Related Identity Theft Remains a Growing Problem.***

The rising IRS caseload may reflect an overall increase in *tax-related* identity theft as opposed to other types. The Federal Trade Commission (FTC) reports overall identity theft complaints have actually decreased in 2009 for the first time since 2006.<sup>15</sup> However, tax return-related identity theft has increased nearly six percentage points from 2006 to 2008.<sup>16</sup> The overall decline in incidents reported to the FTC may be attributable in part to the IRS's

<sup>13</sup> Taxpayer Advocate Management Information System (TAMIS), FY 2009, FY 2010, FY 2011.

<sup>14</sup> See CBS 3 News Report, *Deceased Riverside Child's Identity Stolen, Falsely Claimed on Taxes* (Mar. 1, 2011), available at <http://philadelphia.cbslocal.com/2011/03/01/diseased-riverside-childs-identity-stolen-falsely-claimed-on-taxes>; *The Spread of Tax Fraud by Identity Theft: A Threat to Taxpayers, A Drain on the Public Treasury*, Hearing Before the S. Comm. on Finance, Subcommittee on Fiscal Responsibility and Economic Growth, 112th Cong. (May 25, 2011) (statement of Terry D. McGlun, Jr.).

<sup>15</sup> See Federal Trade Commission, *Consumer Sentinel Data Book 5* (Feb. 2010), available at <http://www.ftc.gov/sentinel/reports/sentinel-annual-reports/sentinel-cy2009.pdf>.

<sup>16</sup> See Federal Trade Commission, *Consumer Sentinel Data Book 3* (Feb. 2009), available at <http://www.ftc.gov/sentinel/reports/sentinel-annual-reports/sentinel-cy2008.pdf>.

creation of its own identity theft affidavit in 2009.<sup>17</sup> Additionally, the victims are sometimes deceased individuals, who cannot report the incidents to the FTC.

One example of alleged tax-related identity theft involves what media reports describe as a sophisticated ring based in the Tampa area. The media reported the individuals allegedly were using laptops, off-the-shelf tax preparation software, wireless hotspots, and easily obtainable personal information to file false returns and obtain refund checks or debit cards. Federal investigators estimate they have seized \$100 million in questionable tax refunds from the operation, which authorities say adopted the name of the popular tax-filing software “Turbo Tax.”<sup>18</sup>

### *The Public Is Increasingly Aware of Identity Theft.*

The increase in identity theft cases may also be due to increased public awareness. Whether because of more effective outreach or just greater media coverage, people may be checking their credit reports more frequently and becoming better at detecting identity theft. If they see suspicious entries on their credit profiles, taxpayers may contact the IRS to make sure no one has used their SSNs to file returns.

### *The IPSU Is Struggling to Effectively Manage Identity Theft Cases.*

The establishment of the Identity Protection Specialized Unit may have created a false sense of well-being in the IRS. Commissioner Shulman, in his written response to Senate Finance Committee Chairman Max Baucus’s follow-up questions after an April 2008 hearing, described the unit as providing “a central point of contact for the resolution of tax issues caused by identity theft.” His response further stated: “This unit will provide end-to-end case resolution. Victims will be able to communicate with one customer service representative to have their questions answered and issues resolved quickly and efficiently.”<sup>19</sup> While this description fits the model for which TAS advocated, it does not accurately reflect how the IPSU operates in practice.

The reality is that the IPSU does not work identity theft cases from beginning to end. Whether because of resource constraints or a policy decision, the IPSU is not staffed to work identity theft cases itself. Instead, it attempts to coordinate with up to 27 other functions within the IRS to obtain relief for the victim.<sup>20</sup> In some cases, the IPSU simply routes

<sup>17</sup> See Form 14039, *Identity Theft Affidavit* (rev. Mar. 2010), available at <http://www.irs.gov/pub/irs-pdf/f14039.pdf>. Prior to 2009, identity theft victims could obtain an identity theft affidavit from the FTC and submit it to the IRS to receive assistance. See IRM 21.6.2.4.4.3(1) (Oct. 1, 2007) (superseded). The IRS still advises taxpayers, by telephone and notices, to file a complaint with the FTC. Filing a complaint to enter an incident in the FTC database is different from completing the FTC identity theft affidavit.

<sup>18</sup> See Elaine Silvestrini & Lauren Mayk, *Police: Tampa Street Criminals Steal Millions Filing Fraudulent Returns*, Tampa Bay Tribune (Sept. 1, 2011), available at <http://www2.tbo.com/news/politics/2011/sep/01/11/police-tampa-street-criminals-steal-millions-filin-ar-254724/>.

<sup>19</sup> *Identity Theft: Who's Got Your Number, Hearing Before the S. Comm. on Finance*, 110th Cong. (Apr. 10, 2008) (response of IRS Commissioner Douglas H. Shulman to questions from Chairman Max Baucus), available at <http://finance.senate.gov/hearings/hearing/download/?id=f989b16e-5da3-452d-9675-b75d796fe2b4>.

<sup>20</sup> IRS, Identity Theft Executive Steering Committee, *Identity Theft Program Enhancements, Challenges and Next Steps* 14 (Oct. 19, 2011).

the case to other IRS organizations and “monitors” the victim’s account every 60 days.<sup>21</sup> In other cases (*e.g.*, those with a systemic burden issue), the unit uses Identity Theft Assistance Requests (ITARs) to ask other IRS functions to take specific actions.<sup>22</sup>

While the procedures call for the receiving functions to give ITARs priority treatment, there are no “teeth” to ensure that happens.<sup>23</sup> Unlike TAS, which can issue a Taxpayer Assistance Order<sup>24</sup> (TAO) if an operating division (OD) does not comply with its request for assistance in a timely manner, the IPSU procedures do not specify any consequences for functions that are unresponsive to a case referral or an ITAR. Moreover, TAS has negotiated agreements with the operating divisions that clearly define when and how the ODs will respond to a TAS request for action. The National Taxpayer Advocate urges the IPSU to enter into similar Service Level Agreements (SLAs) with other IRS divisions and functions that set forth the timeframes for taking the requested action and to develop tracking procedures to report to heads of office when functions regularly fail to meet these timeframes. For example, the SLAs may set forth a reporting mechanism that would notify the executives of other functions when their employees do not meet timeliness standards. The SLAs may also require the ODs to publish their identity theft case timeliness measures in their quarterly Business Performance Review reports.

IPSU procedures are a vast improvement over IRS processes in effect as recently as three years ago. Unless the IPSU is given adequate staffing and authority to oversee cases from start to finish, however, the benefits of these improvements will be inadequate for both taxpayers and the IRS.

**Even with a Specialized Approach to Assisting Identity Theft Victims, the IPSU Should Continue to Play an Important Role.**

Despite its “specialized” name, the IPSU actually operates as a hub in a centralized environment. One major recommendation from the identity theft working group was that the IRS create a specialized unit *within each function* to work on identity theft cases. Under this approach, each function would retain responsibility for individual aspects of a case, but would rely on employees who receive specialized training to help the victims.

The National Taxpayer Advocate believes the IPSU should continue to play an important role in this specialized environment. The IRS needs a “traffic cop” to work with the various functions, hold them to timeframes, and ensure that they do not neglect cases. The IPSU should remain the single point of contact for victims and should coordinate with the

<sup>21</sup> IRM 21.9.2.4.3(7) (Oct. 31, 2011).

<sup>22</sup> IRM 21.9.2.10.1 (Oct. 1, 2010).

<sup>23</sup> IRM 21.9.2.1(4) (Oct. 1, 2011) provides:

All cases involving identity theft will receive priority treatment. This includes... Form 14027-A *Identity Theft Case Monitoring*, and Form 14027-B, *Identity Theft Case Referral*...Identity Theft Assistance Request (ITAR) referrals are also included. IRM 21.9.2.10.1(1) (Oct. 1, 2011) provides that “Cases assigned as ITAR will be treated similar to Taxpayer Advocate Service (TAS) process including time frames.”

<sup>24</sup> See IRC § 7811.

specialists in the various functions. Each function should have a liaison with the IPSU and be held accountable for meeting established deadlines for taking requested actions (as set forth in the SLA).

### **The IRS Does Not Accurately Track Identity Theft Cases or Cycle Time.**

The IRS does not yet have a centralized system to track identity theft cases and must pull data from multiple systems to estimate case receipts. Because identity theft often involves multiple tax issues that need to be worked by different functions, a case frequently appears on multiple systems. A task force determined that the IRS has 22 distinct systems and data sources that collect identity theft data.<sup>25</sup> Without conducting manual workarounds to manipulate the data, the IRS is susceptible to double- or triple-counting identity theft receipts if it simply adds up the case counts from the 22 systems.

Equally important, the IRS does not currently track any data about the cycle time for identity theft cases, although it recognizes the benefits of such a measure. The National Taxpayer Advocate believes that cycle time is useful as an indicator, but urges the IRS to focus more on *timeliness*. Because TAS routinely deals with complicated cases that may take months to fully resolve, TAS case advocates are measured on the timeliness of their actions rather than simply on how long it takes to close a case. For example, did the case advocate phone the taxpayer within one day of the initial contact? Did the case advocate follow up with the appropriate IRS function within three days of the negotiated completion date? Focusing on timeliness (1) requires the case advocate to come up with a detailed action plan to resolve the case and (2) alleviates the artificial pressure to prematurely close the case solely to reduce cycle time. Identity theft cases are similarly complicated and should be measured on timeliness, rather than strictly on cycle time.

Without the ability to compile meaningful identity theft case tracking data, it is difficult, if not impossible, for the IRS to determine whether identity theft cases are being treated with the urgency they demand.

### **The Federal Government Facilitates Tax-Related Identity Theft by Publicly Releasing Significant Personal Information of Deceased Individuals.**

SSNs and other personal information are more accessible than ever. What is surprising and disturbing is that the federal government is the source of much of this personal information. Under a 1980 consent judgment resulting from a Freedom of Information Act (FOIA) lawsuit, the SSA was required to provide certain personally identifiable information about deceased individuals.<sup>26</sup> In response, the SSA created a “Death Master File” (DMF) containing the full name, SSN, date of birth, date of death, and the county, state, and ZIP

<sup>25</sup> IRS, Identity Theft Assessment and Action Group, *IRS Identity Theft Program Future State Report* 8, 136 (Oct. 11, 2011).

<sup>26</sup> See *Perholtz v. Ross*, Civil Action No. 78-2385 and 78-2386, U.S. District Court for the District of Columbia (Apr. 11, 1980).

code of the last address on record.<sup>27</sup> Today, anyone who conducts a quick web search can find a number of sites (including genealogy sites) that provide this information, for free or for a nominal fee.<sup>28</sup>

The National Taxpayer Advocate is appalled that the federal government is making sensitive personal information so readily available, when such information can easily be used to commit identity theft. Notably, the DMF contributes to tax-related identity theft by providing the date of birth, allowing thieves to determine which decedents are minors who can be claimed as dependents. While the Freedom of Information Act may require disclosure of this information, the IRS should work with the SSA to explore ways to minimize the potential harm associated with such information. For example, the SSA provides weekly updates to the DMF. Perhaps the DMF could be released once a year to the public, after the tax filing season. The IRS would continue to receive DMF data on a weekly basis, and thus would have time to load information onto its systems and be better positioned to scrutinize claims that include the SSNs listed in the DMF.

Alternatively, the SSA, perhaps in conjunction with the IRS, may propose to make public only the final four digits of decedents' SSNs, at least for several years after their deaths, to prevent the theft and misuse of their identities. If the federal government can show that the release of full SSNs is substantially furthering criminal conduct and that it reasonably believes the public benefits of partially redacting SSNs outweigh the public benefits of the release of full SSNs, we think a court would give such a request favorable consideration.

If neither of these approaches yield the desired result, the National Taxpayer Advocate is proposing that Congress pass legislation to restrict disclosure of certain personally identifiable information to the public.<sup>29</sup>

**When the IRS Implements New Filters, It Should Have an Effective and Expedited Mitigation Strategy to Help Legitimate Taxpayers Obtain Their Refunds on a Timely Basis.**

In the current environment, the IRS is under tremendous pressure to protect Treasury revenue from improper refund claims. The IRS is understandably deploying front-end verification procedures to prevent suspicious refunds from going out. For the 2012 filing season, the IRS plans to implement a set of identity theft filters it developed by analyzing a population of tax returns that included "verified" false returns along with known legitimate returns. Based on analysis of the differences between these "good" and "bad" returns, the IRS has developed a series of business rules that aim to filter out the verified false returns, while allowing the good returns to pass through processing. The IRS plans to notify

<sup>27</sup> See Office of the Inspector General, SSA, *Personally Identifiable Information Made Available to the General Public Via the Death Master File*, A-06-08-18042 (June 2008).

<sup>28</sup> See Scripps Howard News Service, *ID Thieves Cashing in on Dead Children's Information* (Nov. 3, 2011).

<sup>29</sup> See Legislative Recommendation: *Restrict Access to the Death Master File*, *infra*. See also Identify Theft and Tax Fraud Prevention Act, S. 1534, 112th Cong. § 9 (1st Sess. 2011) (proposing restrictions on access to the Death Master File).

taxpayers whose returns it has flagged that it has questions about their returns and will not be able to process them until the taxpayers provide the requested information.

The National Taxpayer Advocate appreciates the need for the IRS to develop effective screening mechanisms to combat identity theft. However, she has several concerns about the planned filters. First, filters of this nature are inherently imprecise, so it is critical that the IRS employ reliable methods to determine whether a return flagged as questionable is valid or false. Indeed, IRS personnel generally do seek to “validate” or “verify” whether a flagged refund claim should be paid. However, this process often produces inaccurate results. According to a TAS review of approximately 20,000 TAS pre-refund wage verification cases in which refunds were denied, 80 percent of the taxpayers ultimately were found eligible for refunds, with 72 percent receiving the entire amounts they had claimed on their returns.<sup>30</sup> While TAS cases may not be representative of the overall population of taxpayers, the review raises questions about the accuracy of the IRS’s processes and its claims concerning the number and percentage of “verified” false returns.

Second, the National Taxpayer Advocate is concerned that the IRS’s mitigation strategy may not be effective. According to the plan, employees of the Submission Processing organization will be able to help taxpayers erroneously caught up in the identity theft filter. These employees are to retrieve the tax return information and make sure the return is treated as processed on the original date of filing. In the current budget environment, there is a significant risk that Submission Processing will not have sufficient staffing to aid the impacted taxpayers (a number which is unknown at this time).

Third, the National Taxpayer Advocate is concerned that procedural changes adopted through Servicewide Electronic Research Program (SERP) alerts or other staff instructions often have a significant impact on taxpayer mitigation strategies yet are not reviewed by TAS or other affected functions. To protect against that, we urge the IRS to require that any proposed modifications to its mitigation strategies be approved in advance by the Identity Theft Executive Steering Committee.

Fourth, the National Taxpayer Advocate is concerned that the IRS is underestimating the impact of these identity theft filters. During the 2011 filing season, when the IRS vastly underestimated the problems involved in processing repayments of the First-Time Homebuyer Credit, it had no communication strategy to inform the public about these issues. The IRS’s silence drove taxpayers to vent their frustrations and share often inaccurate information on a Facebook page.<sup>31</sup> The IRS should learn from this experience and develop a national communication strategy now. It is important for the IRS to keep taxpayers better informed, especially if it becomes apparent that the identity theft filters will impact a significant number of taxpayers. Moreover, if the IRS’s suspicions are correct and

<sup>30</sup> See Most Serious Problem: *The IRS’s Wage and Withholding Verification Procedures May Encroach on Taxpayer Rights and Delays Refund Processing*, *supra*.

<sup>31</sup> See National Taxpayer Advocate Fiscal Year 2012 Objectives Report to Congress 28-32.

it receives an unprecedented number of returns involving identity theft in the 2012 filing season, it may have to slow down the processing of all returns to protect revenue. The IRS must have a nationwide communication plan in place if that happens.

**The IRS Is Not Adequately Protecting Identity Theft Victims by Quickly Acting Upon Criminal Investigation and Other Identity Theft Referrals.**

The Criminal Investigation division and other agencies sometimes investigate large-scale identity theft schemes and in the course of their investigations acquire lists of taxpayers whose identities have been or may be misused. When CI efforts or referrals from law enforcement agencies yield names and SSNs of impacted taxpayers, the IRS should not only try to protect revenue but should also help the victims. The IRS should promptly (1) place a civil freeze code on such accounts to prevent refunds from being processed without further scrutiny; (2) abate taxes, penalties, and interest from the impacted accounts, as appropriate; and (3) to the extent permitted by law, share this information with other agencies (such as the SSA) to reduce the effect of improperly inflated income.

***The IRS Should Develop a Civil Freeze Code to Protect Revenue.***

Historically, CI would input a TC 918 freeze code to flag accounts when it received leads from law enforcement agencies about SSN misuse. This code would protect revenue and control accounts. The downside of CI applying this code is that the civil functions of the IRS would no longer control the account and be unable to adjust the account or even discuss it with taxpayers. The IRS is considering the development of a civil freeze code that would allow Wage & Investment employees to talk with affected taxpayers and make adjustments while protecting revenue. However, the National Taxpayer Advocate is concerned that W&I employees will not have the expertise and experience to evaluate the merits of a referral from a law enforcement agency. With the mounting external pressure to protect revenue and limited resources to work cases, we are concerned that refund claims that are merely “suspicious” or “potentially fraudulent” may be permanently frozen. To address this concern, the National Taxpayer Advocate recommends that CI remain involved in the decision to implement a TC 918-equivalent freeze code. Only after CI personnel determine that a freeze code is warranted should W&I apply the TC 918-equivalent.

***The IRS Has Not Developed Consistent Guidance for Its Employees to Promptly Remove Fraudulent Income and Credits Related to the Substantiated Identity Theft from the Victims’ Accounts.***

In June 2011, the National Taxpayer Advocate issued a Proposed Taxpayer Advocate Directive (TAD) ordering the Commissioner of W&I to establish procedures to adjust a taxpayer’s account in instances where a tax return preparer altered the return without the taxpayer’s knowledge or consent.<sup>32</sup> To date, the IRS has not issued this guidance to its employees. In August 2011, the National Taxpayer Advocate issued TAOs in four cases

<sup>32</sup> See Proposed Taxpayer Advocate Directive (TAD) 2011-1 (June 13, 2011). This Proposed TAD is attached at the end of this Most Serious Problem.

ordering the Commissioner of W&I to adjust the accounts to remove all entries attributable to the purported returns. It was not until the National Taxpayer Advocate elevated the four TAOs to the Deputy Commissioner of Services and Enforcement in September 2011 (after W&I failed to respond) that the IRS took action in these particular cases. The Proposed TAD remains outstanding and unsatisfied, despite the W&I Commissioner's commitment to develop procedures.

*The IRS Currently Has Sufficient Authority to Share Information Pertaining to Identity Theft with Other Federal Agencies and Should Do So Promptly to Minimize the Impact on Identity Theft Victims.*

The IRS periodically receives referrals from law enforcement agencies that have uncovered an identity theft scheme. If a victim is receiving certain Social Security benefits, his or her benefits may be affected if the perpetrator reported inflated income using the victim's SSN. When the IRS receives such information, it has an obligation to notify both the victim and other agencies (such as the SSA) to minimize the impact to the victim. It should identify a liaison within the SSA and ensure that income information the SSA relies upon to process benefits is accurate.

Identity theft heightens historic concerns with security of return information. While the law generally makes return information confidential, there are various exceptions that allow the IRS to share certain information with the SSA.<sup>33</sup> When the IRS corrects an item of return information (by audit or otherwise), it incorporates updated data into the authorized release.<sup>34</sup> If the IRS corrects an item of return information due to identity theft, it likewise incorporates the correction into the authorized release for corresponding adjustment by the SSA.<sup>35</sup>

Conversely, law enforcement agencies that need return information can obtain it through proper procedures.<sup>36</sup> Federal officials can request return information for use in criminal investigation or proceedings, such as those relating to identity theft.<sup>37</sup> Effective use of existing authority can help stem identity theft.

<sup>33</sup> See, e.g., IRC § 6103(l)(1), (5), (7), (12), (21).

<sup>34</sup> See IRM 11.3.29.3 (Sept. 1, 2009); *Agreement Between the Social Security Administration and the Internal Revenue Service* (Mar. 14, 2007).

<sup>35</sup> Additionally, IRC § 6103(i)(3)(A) authorizes the IRS to apprise another federal agency charged with enforcement of a non-tax crime. To the extent that the Social Security Act criminalizes elements of identity theft (under 42 USC § 1307 or other provisions), this disclosure statute may apply to the agency charged with enforcement.

<sup>36</sup> See IRC § 6103(i)(1), (i)(2); see also IRC § 6103(d) (permitting disclosure to state tax enforcement agencies).

<sup>37</sup> See IRC § 6103(i)(2). In case of tax data provided by an individual that is classified as "taxpayer return information," a federal prosecutor may obtain a court order for release in criminal investigation or proceedings. See IRC § 6103(i)(1).

### **The IRS Issued Identity Protection PINs that Should Protect Some Victims from Refund Delays and Protect Revenue.**

For the 2012 filing season, the IRS issued identity protection personal identification numbers (IP PINs) to over 200,000 victims whose identities and addresses have been verified.<sup>38</sup> In November 2011, the IRS sent out letters informing the victims that they must use the IP PIN to file their 2011 returns electronically. In December 2011, the IRS issued a second letter that actually contained the IP PIN. If the taxpayer attempts to e-file without that number, the IRS will not accept it and the taxpayer will need to file a paper return, which will delay processing.

The National Taxpayer Advocate supports the IP PIN in concept. However, we recognize that some taxpayers will not receive the notification letter, will lose the IP PIN, or will simply forget to use it when they try to e-file. The IRS must be prepared to respond to phone inquiries from these taxpayers and must be prepared, without the need for TAS involvement, to expedite return processing for those victims who demonstrate that identity theft has caused economic hardship. Absent such a mitigation strategy, this policy decision by the IRS may dramatically increase TAS's caseload.

### **The IRS Should Promptly Notify Victims of Identity Theft that Their SSNs Have Been Compromised in the Tax Context.**

When the IRS discovers and confirms that a taxpayer's SSN was used without authorization to file a tax return, it should immediately disclose to the SSN owner that the number has been used on another return and that he or she is an apparent victim of identity theft. In many instances, the IRS is the first agency to learn of the theft. For example, a taxpayer's SSN may have been used by someone else for employment purposes. Where the IRS is able to verify without contacting the taxpayer that misuse has occurred, it can adjust the victim's account without notifying the taxpayer that his or her SSN has been compromised.

In 2008, the IRS Office of Chief Counsel advised that the IRS could notify taxpayers that they were the victims of identity theft without violating confidentiality laws.<sup>39</sup> Based on this advice, the IRS developed a letter informing the taxpayer that his or her personal information has been compromised and providing suggestions about what the taxpayer may wish to do (*e.g.*, contact the credit reporting agencies). However, the IRS does not send such notification in all known instances of identity theft. For example, the IRS does not send such letters to victims of employment-related identity theft.<sup>40</sup>

<sup>38</sup> IRS, Identity Theft Executive Steering Committee, *Identity Theft Program Enhancements, Challenges and Next Steps* 6 (Oct. 19, 2011).

<sup>39</sup> IRS Office of Chief Counsel Memorandum, *Identity Theft Returns and Disclosures Under Section 6103*, PMTA 2009-024 (June 8, 2008).

<sup>40</sup> Email correspondence from Office of Privacy, Government Liaison, and Disclosure analyst (Nov. 2, 2011). The IRS does issue victim notification letters to CI-identified taxpayers. See IRM 10.5.3.2.2.4.3 (Dec. 23, 2010).

### **Taxpayers Should Be Allowed to Turn Off Their Ability to File Tax Returns Electronically.**

Electronic filing has many benefits, including more accurate returns and faster processing. “IRS e-file is the best option for everyone, especially for people impacted by recent tax law changes,” said Commissioner Shulman when IRS e-file approached the milestone of one billion returns processed in January 2011.<sup>41</sup> Twenty years after the IRS introduced e-file, nearly 70 percent of U.S. taxpayers use it.<sup>42</sup>

Unfortunately, the benefits of e-file also extend to perpetrators of identity theft. E-file allows the thieves to submit falsified returns early and repeatedly, in an attempt to beat the legitimate taxpayer to the IRS and claim improper refunds. The mandatory use of the IP PIN would go a long way toward alleviating recurring identity theft, but it would not help taxpayers who no longer have a filing obligation (or young children who do not need to file for many years to come). The IRS should allow taxpayers to voluntarily turn off the ability to e-file using their SSN and enable taxpayers to reacquire the e-file option later, upon proof of identity, if circumstances change. Such a feature would offer an additional level of protection to vulnerable taxpayers.

### **The IRS Should Include TAS Representatives in All Levels of Identity Theft Program and Procedural Planning.**

As discussed, the IPSU functions as a traffic cop, coordinating with various IRS functions to address bits and pieces of an identity theft victim’s tax issues. By contrast, TAS employees are the only IRS employees who work identity theft cases from start to finish. Their global perspective, along with the experience they have gained from working the significant volume of identity theft cases that TAS receives, qualifies some TAS employees as experts in identity theft processing. To ensure the IRS receives the benefit of TAS’s broad experience in assisting identity theft victims, the IRS should include TAS in all levels of identity theft program and procedural planning, including front-line teams, training development, guidance, and advisory and executive steering committees.

## **CONCLUSION**

In conclusion, the National Taxpayer Advocate preliminarily recommends that the IRS:

1. Implement Service Level Agreements between the Identity Protection Specialized Unit and the various functions that process case referrals and Identity Theft Assistance Requests.
2. Establish timeliness measures for identity theft case actions.
3. Before implementing identity theft filters, develop an effective and expedited mitigation strategy to help legitimate taxpayers obtain their refunds on a timely basis.

<sup>41</sup> IRS, *IRS e-file Launches Today; Most Taxpayers Can File Immediately*, IR-2011-4 (Jan. 14, 2011).

<sup>42</sup> *Id.*

4. Require any proposed modifications to its identity theft filters mitigation strategy be approved in advance by the Identity Theft Executive Steering Committee.
5. Create and implement a national communication strategy if the identity theft filters impact a significant number of legitimate taxpayers or cause excessive processing delays.
6. In conjunction with the Social Security Administration, seek a modification of the consent judgment requiring the SSA to release the SSNs of decedents, so that the SSA can begin to partially redact SSNs (*e.g.*, release only the last four digits).
7. If a civil freeze code is implemented for referrals from law enforcement agencies, require CI personnel to determine whether such a refund freeze is necessary before applying the civil freeze code.
8. Establish a point of contact in W&I 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.
9. Promptly notify all victims of identity theft of the misuse of their SSN and provide information about what steps the taxpayer may take to further protect himself or herself.
10. Allow taxpayers to turn off the ability to file electronically.
11. Include TAS in all levels of identity theft program and procedural planning, including front-line teams, training development, guidance, and advisory and executive steering committees.

### IRS COMMENTS

The IRS takes very seriously the issue of identity theft and its impact on the tax system, including the harm that it inflicts on innocent taxpayers. Over the past few years, the IRS has seen a significant increase in refund fraud schemes involving identity theft. The IRS has prioritized this issue and is committed to taking the necessary steps to be better prepared in both fraud prevention and victim assistance. In meeting this commitment, the IRS has substantially increased the resources devoted to both fraud prevention and victim assistance. Even in a declining budget environment, the IRS is taking a variety of steps to address the growing challenge of identity theft.

On the prevention side, the IRS is implementing new processes for handling returns, new filters to detect fraud, new initiatives to partner with stakeholders and a continued commitment to investigate the criminals who perpetrate these crimes. In implementing these processes the IRS must maintain the balance between the processing of refunds in a timely manner with the controls that are needed to minimize errors and fraud in returns that are submitted for processing.

The IRS launched a new program to enhance return processing and catch fraudulent refunds when they come in the door. A cross-functional group made up of IRS divisions developed processes and policies for the 2012 filing season to protect revenue by:

- Designing new identify theft screening filters;
- Developing new procedures to handle returns that are believed to be filed by identity thieves;
- Issuing special identification numbers to taxpayers whose identity has been stolen;
- Identifying mismatches in returns earlier in the process;
- Developing mechanisms to stop the growing trend of returns submitted with deceased taxpayers' information;
- Developing procedures for handling lists of personal information discovered by law enforcement officials;
- Expanding IRS' authority to better utilize the list of prisoners to stop fraudulent returns; and
- Collaborating with software developers and other industries to prevent theft.

In addition, the Criminal Investigation division is working closely with other IRS divisions to improve processes and procedures related to identify theft refund fraud prevention.

Along with prevention, the other key component of the IRS's efforts to combat identity theft involves providing assistance to taxpayers whose personal information has been stolen and used by a perpetrator in the tax filing process. This situation is complicated by the fact that identity theft victims' data has already been compromised outside the filing process by the time we detect and stop perpetrators from using their information.

The IRS agrees that integrated processes and procedures are needed to ensure that identity theft victims receive timely assistance. We recently initiated a focused effort to improve the overall end-to-end case resolution process. A servicewide group was formed to assess the current strategic and operational state of identity theft across the IRS. This effort identified several process and workflow enhancements that will significantly improve our victim assistance services. Because identity theft can manifest within multiple IRS functions, the IRS is establishing specialized groups within each function that encounters identity theft issues. The IRS is working to speed up case resolution, provide more training for employees who assist victims of identity theft, and step up outreach to and education of taxpayers so they can prevent and resolve tax-related identity theft issues quickly. The IRS is also capturing additional data about identity theft cases and integrating this with more robust management oversight processes. In combination, these processes, structural and oversight improvements are targeted to reduce the time required to resolve taxpayer issues and deliver a higher quality of taxpayer service.

Fighting identity theft will be an ongoing battle for the IRS, and one where we cannot afford to let up. The identity theft landscape is constantly changing, as identity thieves continue to create new ways of stealing personal information and using it for their gain. We must continually review our processes and policies to ensure that we are doing everything possible to minimize the incidence of identity theft and to help those who find themselves victimized by it.

As we continue our efforts in this area, we will continue to take into account the views of the National Taxpayer Advocate. With regard to the report's preliminary recommendations, we offer the following comments.

As discussed, the IRS recently has made a number of significant improvements and we continue to work to define our processes and procedures in this area. Due to the risk that specific information about these processes and procedures could be used to facilitate fraud, we are unable to publicly disclose all of our improvements with specificity.

We have greatly improved our internal coordination throughout the operating divisions and criminal investigations in dealing with identity theft issues. We will consider whether implementing Service Level Agreements between the Identity Protection Specialized Unit and the various functions is necessary. The role of the IPSU will be reviewed and modified as the various operating units begin to stand up specialized teams. We will consider whether timelines are necessary, but recognize that given the complexity of the work required in the mitigation of identity theft issues and because multiple business operating divisions will have specialized units to address their unique issues, one standardized measure may not be applicable to all situations.

The IRS is making every effort to minimize the impact of identity theft filters on legitimate taxpayers. The growth in identity theft requires the IRS to put in place new methods to stop refund fraud. We recognize that these efforts could slow refunds for some taxpayers, but we are making every effort to minimize the impact. Our communication strategy will be implemented for the filing season as appropriate.

With respect to a mitigation strategy to help legitimate taxpayers obtain their refunds on a timely basis, the IRS plans to issue a letter to filers within days of their return being identified as having a potential issue. This new letter was shared with the National Taxpayer Advocate. IRS employees will be prepared to answer calls related to the letter and equipped with procedures to post the return and allow the refund when it is determined the return was filed by a legitimate taxpayer. The IRS is also testing the filters on returns prior to the filing season to assess their accuracy.

The IRS actively notifies victims and marks taxpayer accounts when we identify that a Social Security number has been misused. We have developed a specific indicator to note taxpayer accounts when the IRS first determines that there is a likelihood of identity theft. After these accounts are marked, taxpayers receive a notice that informs them of the SSN

misuse and that their tax accounts have been corrected and marked with the identity theft indicator. We also include information on steps that taxpayers should take to protect their identities. We have issued guidance through the IRM on how to apply the account indicator and when to send a notification letter to the victim. We have several additional initiatives underway to expand our processes to notify and assist identity theft victims.

The IRS supports efforts to prevent Social Security Administration death information from public availability as such information significantly contributes to identity theft in the tax system.

The electronic filing of tax returns creates multiple benefits for taxpayers including increased accuracy of filed returns, expedited refunds and ease of use. The IRS recognizes that these same benefits are sometimes exploited by those who choose to perpetrate fraud through identity theft. We have started to offer the Identity Protection Personal Identification Number to protect known identity theft victims and prevent subsequent fraudulent filings using their stolen identity. We are taking several additional steps in this regard.

The IRS looks forward to continued collaboration with the National Taxpayer Advocate on the servicewide tax related identity theft program.

### Taxpayer Advocate Service Comments

The National Taxpayer Advocate applauds the IRS for bringing the IP PIN into service in advance of the 2012 filing season, one of the many process improvements the IRS has made over the years to assist victims of identity theft. However, despite even the best communication efforts, some taxpayers will inevitably need to contact the IRS because they either never received the IP PIN or have misplaced it. The National Taxpayer Advocate reiterates the need for the IRS to develop and implement mitigation strategies as part of its normal planning. In other words, not every taxpayer who loses the IP PIN should be referred to TAS, even if he or she meets TAS criteria.<sup>43</sup> Instead, the IRS's mitigation strategy should anticipate the need for taxpayers who require a replacement IP PIN. It should allocate sufficient staffing, develop adequate procedures, and conduct the necessary training to help these taxpayers, with minimal impact to TAS.

While the IRS recognizes the need for a time-tracking measure for identity theft cases, it states a standardized cycle time measure may not be desired, due to the complexity and uniqueness of such cases. The National Taxpayer Advocate agrees, and suggests that the

<sup>43</sup> See IRM 13.1.7.4 (Oct. 1, 2001) (providing that "Problems that meet TAS criteria do not necessarily need to be sent to TAS when they can be immediately resolved by an operating division or function...Cases that can be resolved on the "Same Day" should not be referred to TAS unless the taxpayer makes the request.").

IRS focus on *timeliness*, rather than cycle time, in developing measures for identity theft cases. By focusing on timeliness of actions, the IRS can give its employees an incentive to keep identity theft cases moving. Whether a case involves one issue for one tax year, or six issues spanning four tax years, a timeliness measure would allow the IRS to assess whether the case truly needed a long time to resolve, or whether the case was languishing in one IRS department with no action.

The National Taxpayer Advocate is pleased to report that some genealogy websites have voluntarily agreed to curtail the availability of Death Master File information. Ancestry.com recently announced it will no longer display SSNs for anyone who has passed away within the past ten years.<sup>44</sup> RootsWeb.com, another genealogy site affiliated with Ancestry.com, states that it will not share information from the DMF “due to sensitivities around the information in this database.”<sup>45</sup> These changes appear to be in response to congressional and media pressure, and should make it more difficult for identity thieves to file false tax returns. It is our hope that other websites will follow suit, and that the SSA (or Congress, if necessary) will restrict access to the DMF to those with a legitimate need for such sensitive information. The National Taxpayer Advocate commends the IRS for its support of these efforts.

Finally, the National Taxpayer Advocate is pleased that the IRS has committed to working with and including TAS on servicewide teams to address identity theft issues and procedures. She urges the IRS to include TAS representatives at all levels of planning, given TAS’s unique and extensive experience with identity theft cases.

<sup>44</sup> See Ancestry.com, *Why Was the Social Security Death Index Recently Changed?* [http://ancestry.custhelp.com/cgi-bin/ancestry.cfg/php/enduser/sab\\_answer.php?p\\_faqid=5420&p\\_created=1323809913&p\\_sid=utw11BLk&p\\_accessibility=&p\\_redirect=&p\\_lva=&p\\_sp=cF9zcmNoPTEmcF9zb3J0X2J5PSZwX2dyaWRzb3J0PSZwX3Byb2RzPSZwX2NhdHM9JnBfcHY9JnBfY3Y9JnBfcGFnZT0x&p\\_li=&p\\_topview=1](http://ancestry.custhelp.com/cgi-bin/ancestry.cfg/php/enduser/sab_answer.php?p_faqid=5420&p_created=1323809913&p_sid=utw11BLk&p_accessibility=&p_redirect=&p_lva=&p_sp=cF9zcmNoPTEmcF9zb3J0X2J5PSZwX2dyaWRzb3J0PSZwX3Byb2RzPSZwX2NhdHM9JnBfcHY9JnBfY3Y9JnBfcGFnZT0x&p_li=&p_topview=1) (last visited Dec. 19, 2011).

<sup>45</sup> See About.com, *Genealogy Sites Pressured Into Removing SSDI*, <http://genealogy.about.com/b/2011/12/16/genealogy-sites-pressured-into-removing-ssdi.htm> (last visited Dec. 19, 2011); Ancestry.com, *Why Was the Social Security Death Index Recently Changed?* [http://ancestry.custhelp.com/cgi-bin/ancestry.cfg/php/enduser/sab\\_answer.php?p\\_faqid=5420&p\\_created=1323809913&p\\_sid=utw11BLk&p\\_accessibility=&p\\_redirect=&p\\_lva=&p\\_sp=cF9zcmNoPTEmcF9zb3J0X2J5PSZwX2dyaWRzb3J0PSZwX3Byb2RzPSZwX2NhdHM9JnBfcHY9JnBfY3Y9JnBfcGFnZT0x&p\\_li=&p\\_topview=1](http://ancestry.custhelp.com/cgi-bin/ancestry.cfg/php/enduser/sab_answer.php?p_faqid=5420&p_created=1323809913&p_sid=utw11BLk&p_accessibility=&p_redirect=&p_lva=&p_sp=cF9zcmNoPTEmcF9zb3J0X2J5PSZwX2dyaWRzb3J0PSZwX3Byb2RzPSZwX2NhdHM9JnBfcHY9JnBfY3Y9JnBfcGFnZT0x&p_li=&p_topview=1) (last visited Dec. 19, 2011); Scripps Howard News Service, *Genealogy Sites Remove Social Security Numbers of Deceased* (Dec. 15, 2011), available at <http://www.abcactionnews.com/dpp/news/national/genealogy-sites-remove-social-security-numbers-of-deceased>.

## Recommendations

The National Taxpayer Advocate recommends that the IRS:

1. Implement Service Level Agreements between the Identity Protection Specialized Unit and the various functions that process case referrals and Identity Theft Assistance Requests.
2. Establish timeliness measures for identity theft case actions.
3. Before implementing identity theft filters, develop an effective and expedited mitigation strategy to help legitimate taxpayers obtain their refunds on a timely basis.
4. Require any proposed modifications to its identity theft filters mitigation strategy be approved in advance by the Identity Theft Executive Steering Committee.
5. Create and implement a national communication strategy if the identity theft filters impact a significant number of legitimate taxpayers or cause excessive processing delays.
6. In conjunction with the Social Security Administration, seek a modification of the consent judgment requiring the SSA to release the SSNs of decedents, so that the SSA can begin to partially redact SSNs (*e.g.*, release only the last four digits).
7. If a civil freeze code is implemented for referrals from law enforcement agencies, require CI personnel to determine whether such a refund freeze is necessary before applying the civil freeze code.
8. Establish a point of contact in W&I 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.
9. Promptly notify all victims of identity theft of the misuse of their SSN and provide information about what steps the taxpayer may take to further protect himself or herself.
10. Allow taxpayers to turn off the ability to file electronically.

June 13, 2011

MEMORANDUM FOR RICHARD E. BYRD, JR., COMMISSIONER  
WAGE AND INVESTMENT DIVISION

FROM: Nina E. Olson  
National Taxpayer Advocate

SUBJECT: *Proposed Taxpayer Advocate Directive 2011-1 (Establish procedures for adjusting the taxpayer's account in instances where a tax return preparer altered the return without the taxpayer's knowledge or consent, and the preparer obtained a fraudulent refund).*

#### PROPOSED TAXPAYER ADVOCATE DIRECTIVE

I am issuing this proposed Taxpayer Advocate Directive (TAD) to direct the Commissioner, Wage and Investment Division to:

- 1) within ten days of the date of this proposed TAD, cease any collection actions on liabilities assessed against taxpayers in connection with a refund or portion of a refund that the taxpayer never received due to return preparer fraud;
- 2) within 45 days of the date of this proposed TAD, in consultation with the National Taxpayer Advocate, issue interim guidance to establish procedures to abate assessments and correct refund amounts where the IRS is holding a taxpayer liable for repayment of a refund or portion of a refund that the taxpayer never received due to return preparer fraud; and
- 3) within 90 days of the date of this proposed TAD, in consultation with the National Taxpayer Advocate, revise the Internal Revenue Manual (IRM) to provide guidance on abating assessments or correcting refund amounts where the IRS is holding a taxpayer liable for repayment of a refund or portion of a refund that the taxpayer never received due to return preparer fraud.

Please provide a written response to this proposed TAD on or before June 23, 2011.

#### I. Authority

This directive is being issued pursuant to Delegation Order No. 13-3, which grants the National Taxpayer Advocate the authority to issue a TAD to mandate administrative or procedural changes to improve the operation of a functional process or to grant relief to groups of taxpayers (or all taxpayers) when implementation will protect the rights of taxpayers, prevent undue burden, ensure equitable treatment, or provide an essential service to taxpayers.<sup>1</sup> This authority may not be redelegated.

<sup>1</sup> Internal Revenue Manual (IRM) 1.2.50.4, Delegation Order 13-3 (formerly DO-250, Rev. 1), *Authority to Issue Taxpayer Advocate Directives* (Jan. 17, 2001). See also IRM 13.2.1.6, *Taxpayer Advocate Directives*, (July 16, 2009).

In June 2009, Systemic Advocacy Analysts convened a cross-functional team to develop procedures to handle cases where a return preparer defrauded the taxpayer. Since that time, TAS has been working unsuccessfully with the other IRS functions to establish procedures to protect the government's and taxpayers' interests in cases of preparer fraud. On March 23, 2011, Director Jane E. Looney, Accounts Management (AM), informed TAS that AM will not take any action on these accounts, because "investigating preparer fraud and determining if the taxpayer benefitted from the alleged fraud is outside the scope of AM."<sup>2</sup> She did not suggest who within the IRS does have the jurisdiction to implement procedures. Pursuant to IRM 13.2.1.6.1.2, a proposed TAD is an appropriate response to the IRS's failure to implement procedures that would protect the rights of taxpayers and prevent undue burden.

## II. Background

TAS has at least 82 cases where preparers have defrauded the government and harmed taxpayers by filing fraudulent returns to obtain larger refunds than taxpayers expect and are entitled to. These preparers altered taxpayers' tax returns without their knowledge or consent by inflating income, deductions, credits, or withholding. The taxpayers generally received refunds from the preparers in the amount the preparer advised each taxpayer that he or she should receive; each taxpayer became aware of the preparer's fraudulent activity upon hearing from the IRS when it assessed or attempted to collect the erroneous excess refund amount. Here is a basic example to illustrate the actions of the preparer.

Taxpayer A provides her tax return preparer with her W-2 and relevant information. The preparer completes Form 1040, reflecting a zero tax liability, and indicating Taxpayer A is eligible for a \$350 refund. After providing Taxpayer A with a printed copy of that return, the preparer electronically files a different return with the IRS.

Taxpayer A is not aware that the preparer altered the return before he electronically filed it by inflating income and the credit for income tax withholding; the preparer reported a tax liability of \$500 and withholding of \$3850, thereby increasing the refund to \$3,350. Unbeknownst to Taxpayer A, the return preparer designated two bank accounts into which the \$3,350.00 refund is split: \$350.00 is direct-deposited into Taxpayer A's account and the balance of \$3,000.00 is direct-deposited into the preparer's own account. Thus, Taxpayer A has received the refund to which she thought she was entitled, based on the copy of the return she approved and the preparer provided to her.

The IRS selects Taxpayer A's return for examination the following year. The IRS disallows Taxpayer A's excess withholding and proposes a deficiency of \$3,000.00 (plus penalty and interest).

<sup>2</sup> Jane E. Looney, Memorandum re: *Taxpayer Assistance Order \*\*\*\*\** (Mar. 23, 2011) (taxpayer name redacted).

In cases where a tax liability in excess of the taxpayer's true liability is assessed as a result of the preparer's actions, the IRS has refused to abate the excess tax as required by law and per advice from the Office of Chief Counsel, discussed below. In addition, even if the preparer's actions resulted in a larger refund than what the taxpayer was entitled to receive but did not result in an additional tax assessment, the IRS has refused to adjust the taxpayers' accounts for the erroneous balances due from the fraudulent portions of the refunds. Instead, the IRS holds taxpayers liable for any understatement of tax, penalties, and interest, as well as the amount of the refund that the IRS issued to the preparer. The IRS's failure to provide guidance to its employees about the proper handling of this type of case is evident by the following response received from Accounts Management in response to an Operations Assistance Request issued by TAS:

The refund was traced and the financial institution indicates that the refund was deposited as requested and the funds are not available - per IRM 21-4.1.3.4 NOTE: If the taxpayer alleges preparer fraud as the reason for non-receipt of the refund, advise the taxpayer that while the IRS will conduct a trace to determine the deposition of the refund, the restoration of the refund to the taxpayer may become a civil matter.<sup>3</sup>

In that particular TAS case, the actions of the preparer resulted in the IRS offsetting the taxpayer's refunds in the following two tax years. Instead of offsetting the taxpayer's refunds, however, the IRS should have instituted procedures to adjust the taxpayer's account and not hold the taxpayer liable for the portion of the refund that the preparer received.

### III. Reasons for Issuing this Proposed TAD

The IRS has failed to develop procedures that are consistent with the Internal Revenue Code and legal advice provided by the IRS Office of Chief Counsel. In this regard, Counsel has issued two memorandums (copies attached) that directly relate to this issue. The memorandum regarding *Horse's Tax Service* (Attachment 1) addresses whether an electronically filed tax return that was altered without the taxpayer's knowledge is a valid return.<sup>4</sup> Counsel analyzed the four-part test set forth in *Beard v. Commissioner*,<sup>5</sup> and concluded that when the taxpayer is unaware of the alterations to the return and the version that the taxpayer reviewed is not what the preparer filed with the IRS, the taxpayer did not sign that return under penalties of perjury. Consequently, the return filed by the preparer is a nullity and any assessment on the IRS's books and records relating to that return is invalid. Counsel further advised that the taxpayer should file an *original* return (not an amended return) so that the IRS can then adjust the taxpayer's Master File account to reflect the correct tax information. Thus, in situations where the taxpayer can prove that the version of

<sup>3</sup> TAS, TAMIS Case File No. 4903292. IRS, OAR 1543701 Response (Jan. 28, 2011).

<sup>4</sup> IRS Office of Chief Counsel, PMTA 2011-013 (May 12, 2003). The name of the preparer was changed to remove the identity of the preparer due to confidentiality concerns.

<sup>5</sup> *Beard v. Commissioner*, 82 T.C. 766, 777 (1984), *aff'd per curiam*, 793 F.2d 139 (6th Cir. 1986). The test for a valid return is: (1) there must be sufficient data to calculate tax liability; (2) the document must purport to be a return; (3) there must be an honest and reasonable attempt to satisfy the requirements of the tax law; and (4) the taxpayer must execute the return under penalties of perjury.

the tax return that he or she reviewed is not the version the preparer filed with the IRS, the IRS should reverse the accounting entries on the taxpayer's module.

Even in situations where the taxpayer cannot produce a copy of a return from the preparer that is different than what the preparer filed with the IRS, Counsel has nonetheless advised that certain adjustments to the taxpayer's account are appropriate so that the taxpayer is not held liable for a refund (or portion thereof) fraudulently obtained by the preparer. In this regard, the memorandum entitled *Refunds Improperly Directed to a Preparer* (Attachment 2) specifically discusses the ability of the IRS to abate any improper amount of tax and withholding based on Internal Revenue Code (IRC) § 6404(a).<sup>6</sup> The memorandum specifically states:

The portion of each refund that reflected the difference between the refund amount the client thought was being obtained and the amount that the Preparer included on the electronically filed return... deposited to the Preparer's account) should be attributed to the Preparer, and not to the client.

While abatement may not be appropriate in every case (*e.g.*, the preparer's actions resulted in a larger refund but did not result in an additional tax assessment, so there would be no tax to abate), the memorandum makes clear that the IRS "can and should adjust" each affected taxpayer's account for any refund (or portion thereof) illegally obtained by the preparer.

Moreover, part of the Wage and Investment Division's mission is "to protect the public interest by applying the tax law with integrity and fairness to all."<sup>7</sup> Requiring a taxpayer to repay a refund that he or she did not receive or have knowledge of is inequitable and unjust. The preparers defrauded the taxpayers by filing altered returns to illegally obtain refunds from the IRS. The IRS should take all available actions to protect taxpayers, to abate any improper assessments, and to expunge the refunds or portion of refunds from the taxpayers' accounts that the preparers received. Otherwise, the IRS itself is victimizing the disreputable preparer's victims.

#### IV. Conclusion

In light of the significant harm taxpayers are suffering as a result of the IRS's inability to develop a process for providing relief to these taxpayers over the last two years, I direct the IRS to:

- Cease any collection actions on liabilities assessed against taxpayers in connection with a refund or portion of a refund that the taxpayer never received due to return preparer fraud within ten days of this directive;

<sup>6</sup> IRS Office of Chief Counsel, POSTN-145098-08 (Dec. 17, 2008).

<sup>7</sup> See [http://win.web.irs.gov/aboutus/aboutus\\_goals.htm#Mission](http://win.web.irs.gov/aboutus/aboutus_goals.htm#Mission) (last viewed May 5, 2011).

- Issue an interim guidance memorandum (IGM), developed in consultation with the National Taxpayer Advocate, within 45 days of this directive; and
- Revise the IRM within 90 days of this directive to instruct IRS employees how to correct the taxpayers' accounts to reflect the removal of the inflated refund received by the return preparer.

I issued the attached interim guidance memorandum that the IRS can use as a model to identify accounts with preparer refund fraud issues and the documentation needed to ensure that taxpayers are only held liable for the actions of their preparer in appropriate circumstances.

Attachments:

- (1) Office of Chief Counsel, PMTA 2011-13, *Horse's Tax Service* (May 12, 2003).
- (2) Office of Chief Counsel, POSTN-145098-08, *Refunds Improperly Directed to a Preparer* (Dec. 17, 2008).
- (3) National Taxpayer Advocate, *Interim Guidance on Recognizing and Assisting Victims of Refund Preparer Theft*, TAS-13.1.10-0311-004 (Mar. 14, 2011).

cc w/attachments: Steve Miller, Deputy Commissioner, Services and Enforcement

## MSP #4

## Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights

### RESPONSIBLE OFFICIALS

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

### DEFINITION OF PROBLEM

Under Internal Revenue Code (IRC) §§ 6213(b) and (g), 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 (TIGTA) and the Government Accountability Office (GAO) have recently urged the IRS to increase its use of this authority, stating that it is a cost-effective way to process new items on tax returns, such as the First-Time Homebuyer Credit (FTHBC).<sup>1</sup> The primary driver behind this call for expansion of IRS math error authority is the desire to protect revenue by preventing the payment of tax refunds where a credit, such as the FTHBC, is claimed improperly. In response to TIGTA and GAO's recommendations, the IRS is considering expanding the use of math error authority to other refundable credits (including the small business health care tax credit and the adoption credit).<sup>2</sup> As these types of refundable tax credits continue to grow, the IRS is more likely to seek expanded math error authority because the dollar amounts at stake become increasingly attractive for both one-time fraud cases and larger schemes.<sup>3</sup> However, failure to narrowly craft and implement math error provisions will harm taxpayers who are trying to comply with their tax obligations.<sup>4</sup>

Math error authority can be an effective processing tool when used appropriately in limited circumstances. The early legislative history of math error authority clearly shows that the deviation from deficiency procedures was intended to be limited in scope.<sup>5</sup> The IRS was to use math error authority only when errors were apparent on the face of the return or from information provided on the return.<sup>6</sup> Its recent expansion to more complicated and facts-and-circumstances-based provisions comes with a high cost for taxpayers, such as a risk

<sup>1</sup> TIGTA, Ref. No. 2011-40-059, *Some Taxpayer Responses to Math Error Adjustments Were Not Worked Timely and Accurately* (July 7, 2011); GAO, GAO 10-349, *Recovery Act: IRS Quickly Implemented Tax Provisions, but Reporting and Enforcement Improvements Are Needed* (Feb. 2010).

<sup>2</sup> IRC §§ 45R and 36C, and IRS Briefing, *Overview of the Accelerated Refund Assurance Program (ARAP)* (Oct. 6, 2011). This briefing sets out areas where the IRS is considering requesting congressional expansion of its math error authority.

<sup>3</sup> See also TIGTA, Ref. No. 2011-40-128, *The Passage of Late Legislation and Incorrect Computer Programming Delayed Refunds for Some Taxpayers During the 2011 Filing Season* (Sept. 28, 2011).

<sup>4</sup> For an in-depth discussion of tax expenditures and the challenges to running social benefits through the Code, see National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 75 (*Running Social Programs Through the Tax System*) and National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 101 (*Evaluating the Administration of Tax Expenditures*).

<sup>5</sup> General Explanation of the Tax Reform Act of 1976, 94th Cong., 2d Sess., 372-74 (1976); 1976-3 (Vol. 2) C.B. 1, 384-86.

<sup>6</sup> H.R. Rep. 94-658, at 183 (Nov. 12, 1979), which defined mathematical or clerical errors as, "Arithmetic" errors, including "errors in addition, subtraction, etc." where "such an error will be apparent and the correct answer will be obvious."

of losing their right to dispute the assessment in Tax Court (the only pre-payment forum available). Inappropriate expansion of math error authority into more complex or fact-intensive areas undermines IRS efficiency by increasing the risk of inaccurate assessments and creating more work downstream for the IRS.

The National Taxpayer Advocate has previously identified problems with the IRS's administration of the math error program and the significant burden it places on millions of taxpayers each year.<sup>7</sup> Taxpayer protections are eroded by unclear notices, post-processed math error assessments, and reliance on inaccurate third-party data systems. In particular, problems with the IRS use of math error authority include the following:

- Math error notices are still not clearly written despite the IRS's efforts to revise them, making it difficult for taxpayers to determine what specifically has been corrected on their returns and decide if they should accept the adjustment or request an abatement.<sup>8</sup>
- The IRS does not process taxpayer responses to math error notices timely.<sup>9</sup> This failure not only delays the math error process but may also delay taxpayers' refunds, which in turn will cause more calls and letters to the IRS, and even Taxpayer Advocate Service cases.
- The IRS often does not work taxpayer responses to math error adjustments accurately. A TIGTA review found that 43 out of the 260 responses it reviewed were not worked accurately,<sup>10</sup> which may be the result of using math error authority in situations where a facts-and-circumstances analysis is more appropriate.
- The IRS can resolve some math error discrepancies through internal research, relieving some of the burden on taxpayers. In fact, as discussed in Volume 2 of this report, *Math Errors Committed on Individual Tax Returns: A Review of Math Errors Issued on Claimed Dependents*, a TAS research study found that missing or incorrect Taxpayer Identification Numbers (TINs) on a return could be reconciled through prior return

<sup>7</sup> National Taxpayer Advocate 2006 Annual Report to Congress 311; National Taxpayer Advocate 2003 Annual Report to Congress 113; National Taxpayer Advocate 2002 Annual Report to Congress 25, 186; National Taxpayer Advocate 2001 Annual Report to Congress 33. See also *Hearing on Improper Payments in the Administration of Refundable Tax Credits Before the Subcommittee on Oversight, Committee on Ways and Means*, 112th Cong. (May 25, 2011) (statement of Nina E. Olson, National Taxpayer Advocate); *Hearing on Complexity and the Tax Gap, Making Tax Compliance Easier and Collecting What's Due Before the Committee on Finance*, 112th Cong. (June 28, 2011) (statement of Nina E. Olson, National Taxpayer Advocate).

<sup>8</sup> TAS study of math error notices conducted by Field Systemic Advocacy, Technical Analysis and Guidance, and Systemic Advocacy Systems (May 22, 2010). Three different technical analysts reviewed more than 500 paragraphs of text explaining problems with the return, IRS changes, and actions required by taxpayers to resolve the problem, and found more than 40 inadequate explanations of IRS changes to the return. Explanations were considered unclear if two of the three analysts found the passages confusing, inaccurate, incomplete, or expansive. This is a conservative estimate since the analysts who conducted the review have extensive experience with IRS documents and likely understood more than the average taxpayer would. The group also reviewed 300 paragraphs for taxpayer notices relating to business returns and did not find any verbiage that multiple analysts thought was inadequate.

<sup>9</sup> TIGTA, Ref. No. 2011-40-059, *Some Taxpayer Responses to Math Error Adjustments Were Not Worked Timely and Accurately* (July 7, 2011). This TIGTA review showed an estimated 12,232 out of 130,616 responses may not have been resolved timely during the specified period (January 1 to July 23, 2010).

<sup>10</sup> *Id.* The errors found in the 260 responses reviewed resulted in the IRS paying \$7,988 in erroneous refunds and incorrectly denying \$5,894 in benefits to taxpayers.

information 56 percent of the time.<sup>11</sup> However, IRS procedures do not permit employees to conduct this kind of research, which would enable them to easily resolve routine matters, such as incorrect entries of dependent TINs on returns.<sup>12</sup> Conducting this type of preliminary research may prevent rework later on. For example, when the IRS used math error authority to disallow exemptions for dependent children on approximately 330,000 returns for tax year (TY) 2006, the IRS was obliged to fully reverse its adjustments about 50 percent of the time.<sup>13</sup>

- Math error authority includes adjustments to returns “post-processing,” which means a taxpayer who thought his or her return had been accepted as filed may be notified months or even years later that the IRS has assessed additional tax due to a math error. This approach confuses taxpayers and does not protect revenue, since refunds are already processed and paid based on the original return. It also confuses the IRS, which can fail to provide or follow certain statutorily mandated rights or procedures.<sup>14</sup>

## ANALYSIS OF PROBLEM

### Background

#### *What the Use of Math Error Authority Means for Taxpayers*

Math error authority enables the IRS to increase its tax return processing capacity by quickly resolving simple mathematical or clerical mistakes and summarily assessing the adjusted tax. If given authority under IRC § 6213(b) or (g), the IRS can make an assessment without filing a statutory notice of deficiency (SNOD).<sup>15</sup> Once the IRS notifies taxpayers of math errors, they have 60 days to request abatement of the additional tax. If the taxpayer makes a timely request, the IRS will abate the assessment and follow formal deficiency procedures to reassess the tax (*i.e.*, send the taxpayer a SNOD).<sup>16</sup> However, if the taxpayer fails to

<sup>11</sup> See National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, *infra* (Math Errors Committed on Individual Tax Returns: A Review of Math Errors Issued on Claimed Dependents). TAS analysis of data collected (manually using a data collection instrument) in October 2011. The sample of records was selected using IRS Compliance Data Warehouse (CDW) Individual Returns Transaction File (IRTF) and Individual Master File (IMF) TY 2009 data. TAS analyzed data collected from a statistically valid sample of 500 accounts with math error codes 604, 605, or 743. The review showed the IRS abated its math error assessment and had internal data available to resolve 56 percent of code 605 and 743 (incorrect dependent TIN) accounts.

<sup>12</sup> See National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, *infra* (Math Errors Committed on Individual Tax Returns: A Review of Math Errors Issued on Claimed Dependents). IRS, IMF Math Error Report (Dec. 24, 2010). In 2010, the IRS issued 10,569,945 IMF math error notices for tax year 2009 returns (and an additional 1,288,746 for prior year returns). In 2010, there were 228,383 notice code 605 (dependent TIN mismatches) reported for TY 2009 (56,014 on prior year returns) and in 2009, 233,558 for TY 2008 (53,712 math errors issued on prior year returns).

<sup>13</sup> TAS analysis of TY 2006 data from CDW IRTF and IMF (Dec. 2010). The analysis found a full abatement or reversal rate of 49.4 percent for the math error notice 605, for invalid dependent TIN, on adjustments to TY 2006 accounts; this is an indicator that the tax was correctly computed by half of this population. There were 162,013 full reversals of the 327,787 returns with notice 605.

<sup>14</sup> See IRS Servicewide Electronic Research Program (SERP) Alert 110514 (July 27, 2011) (announcing the IRS was reversing FTHBC credits based on third-party information showing taxpayers had an ineligible purchase date). During the week of July 27, 2011, the IRS inappropriately issued 36,000 letters disallowing the FTHBC, and without providing an explanation of the taxpayers' statutory right to contest the math error adjustment within 60 days. See also SERP Alert 100512 (Oct. 6, 2010) (directing the reversal of the FTHBC using math error procedures if the taxpayer did not respond with documentation showing a qualifying purchase date).

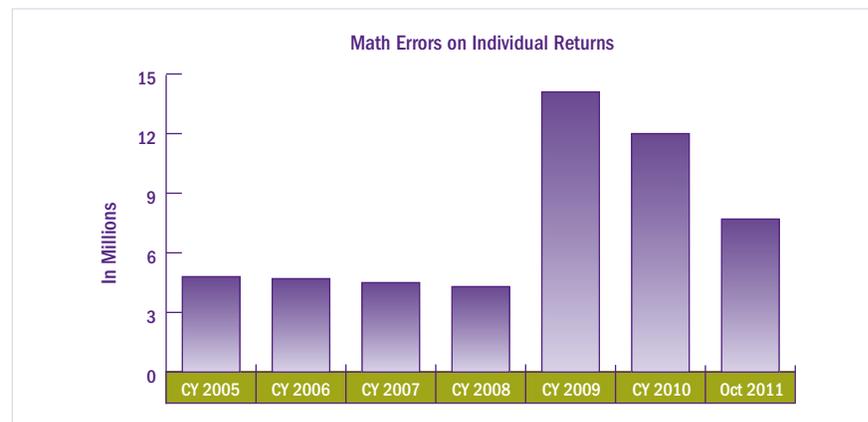
<sup>15</sup> IRC § 6213(b)(2)(A).

<sup>16</sup> *Id.* The ability of a taxpayer to protest a math error assessment, even without substantiating explanation, is addressed in Internal Revenue Manual (IRM) 21.5.4.4.4 (Oct. 1, 2010) and IRM 21.5.4.4.5 (Sept. 9, 2010).

request abatement timely, the IRS may collect the additional tax.<sup>17</sup> At this point, the assessment cannot be appealed in the U.S. Tax Court. This is significant, because the Tax Court is the only pre-payment judicial forum (*i.e.*, the taxpayer does not have to pay the liability to contest the assessment in Tax Court, unlike in Federal District Court or the Court of Federal Claims where the taxpayer has to pay the tax and then file for a refund claim).<sup>18</sup>

In 2010, the IRS sent 10.6 million math errors, compared to only four million in 2005.<sup>19</sup>

**FIGURE 1.4.1, Math Errors on Individual Tax Returns, Calendar Years through 2010<sup>20</sup>**



As illustrated in this chart, the use of math error authority has increased significantly since 2008, as Congress created refundable credits and granted the IRS math error authority to disallow them in an effort to prevent inappropriate payments. Considering the current budget strains on the IRS, and the growing number of large refundable credits, the National Taxpayer Advocate fully expects the number of math error notices to rise even more over the next few years. In fact, the IRS is currently identifying new ways to use its existing authority and exploring areas where new authority could be useful.<sup>21</sup>

### Legislative History

The legislative history shows that Congress, when passing this provision, weighed the benefits of allowing IRS to assess tax quickly in the case of a mathematical or clerical error against the costs to taxpayers of the IRS's summarily assessing tax (*i.e.*, not utilizing

<sup>17</sup> IRC §§ 6213(g)(2)(A) through 6213(g)(2)(E).

<sup>18</sup> IRC § 6511.

<sup>19</sup> IRS Databook 2010, 38. There were 10,554,735 IMF math errors for TY 2009 returns (the IRS determined an additional 1,285,706 math errors on TY 2008 and prior year returns in CY 2010, excluding Forms 1040NR).

<sup>20</sup> IRS, IMF Math Error Reports (Dec. 2005 through Dec. 2010, and Nov 5, 2011). The totals include all individual tax return math errors in each calendar year. Original figures for 2008 were overstated because a counter was not reset at the end of 2007. For this chart, 2008 figures were revised by subtracting 2007 figures from the reported 2008 figures.

<sup>21</sup> IRS Briefing, *Overview of the Accelerated Refund Assurance Program (ARAP)* (Oct. 6, 2011).

deficiency procedures). Considering these two objectives, Congress (1) mandated that IRS follow deficiency procedures when taxpayers timely contest math error adjustments and (2) made clear the kinds of cases in which the IRS could use its limited summary assessment authority.<sup>22</sup> Congress was very specific about the protections given the taxpayer:

The amendment provides that where the Internal Revenue Service uses the summary assessment procedure for mathematical errors ... the taxpayer must be given an explanation of the asserted error... , the taxpayer must be given a period of time during which he or she may require the Service to abate its assessment ... , and the Service is not to proceed to collect on the assessment until the taxpayer has agreed to the assessment or has allowed his or her time for objecting to expire... .<sup>23</sup>

Congress went on to describe what it considered a mathematical error or inconsistent treatment on a return by a taxpayer. “Arithmetic” errors include “errors in addition, subtraction, etc.” where “such an error will be apparent and the correct answer will be obvious.”<sup>24</sup> Additionally, Congress stated that the inconsistent entries category was intended to “encompass those cases where it is apparent which of the inconsistent entries is correct and which is incorrect.”<sup>25</sup> Congress also made it clear that the IRS is not to use summary assessment procedures merely to resolve an uncertainty against the taxpayer.<sup>26</sup>

The current use of math error notices falls well outside these initial parameters, including situations requiring analyses of facts-and-circumstances.

### **Expansion of Math Error Authority Far Exceeds Congress’s Original Purpose and Relies Too Heavily on IRS Discretion.**

As the IRS has begun administering larger and more complex refundable credits such as the Earned Income Tax Credit (EITC), and the FTHBC, Congress has gradually expanded math error authority.<sup>27</sup> It now covers 16 categories of mistakes or omissions.<sup>28</sup>

The most recent example of the types of problems that can occur when math error authority expands beyond its original intention comes from the FTHBC. The credit permitted taxpayers who purchased a principal residence after April 8, 2008, and before July 1, 2009, to claim a credit equal to ten percent of the purchase price (up to \$7,500).<sup>29</sup> The credit operated as an interest-free loan to be paid back over a 15-year period beginning two years after

<sup>22</sup> General Explanation of the Tax Reform Act of 1976, 94th Cong., 2d Sess., 372-74 (1976); 1976-3 (Vol. 2) C.B. 1, 384-86.

<sup>23</sup> S. Rep. No. 938, 94th Cong., 2d Sess. 375 (1976); 1976-3 (Vol. 3) C.B. 49, 413.

<sup>24</sup> H.R. Rep. 94-658, at 183 (Nov. 12, 1979).

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

<sup>26</sup> *Id.*

<sup>27</sup> Besides the five “mathematical or clerical” error types listed in IRC § 6213 (g)(2)(A) through (E), math error authority also includes mistakes such as missing TINs for dependency exemptions or EITC, and missing verification of the FTHBC, in IRC § 6213(g)(2)(F) through (P). IRC §§ 6213(g)(2)(F) and (H) through (P).

<sup>28</sup> IRC § 6213(g)(2).

<sup>29</sup> The credit was established in the Housing and Economic Recovery Act of 2008 (HERA), Pub. L. No. 110-289.

the credit was claimed.<sup>30</sup> During its first implementation period, taxpayers made numerous errors when claiming the credit, and its design exposed the IRS to improper claims from taxpayers trying to take advantage of the system. In 2009, Congress extended and expanded the credit, added documentation requirements, and amended IRC § 6213(g) to include math error authority for the FTHBC.<sup>31</sup>

The math error authority provided in IRC § 6213(g)(2)(O) and(P) applies where the taxpayer 1) omitted the increase in tax required by the recapture provisions included in IRC 36(f); 2) was not 18 years old at the time the home was purchased; 3) provided information on a prior return inconsistent with eligibility for the FTHBC; or 4) failed to attach to the return a copy of the settlement statement.<sup>32</sup> This last provision placed the IRS in the position of making a facts-and-circumstance determination about whether an attached settlement statement was properly executed. While it would seem to be a relatively simple determination, expanding math error authority to include review of the documentation for the FTHBC has caused problems for both the IRS and taxpayers.

**Example:** Initially, the IRS determined that a properly executed settlement statement would need to show all parties' names and signatures, the property address, sales price, and date of purchase. Normally, this is the properly executed Form HUD-1, *Settlement Statement*.<sup>33</sup> If this information was not included, the IRS considered the statement to be not properly executed, and disallowed the FTHBC using math error authority. This approach caused problems for many taxpayers because states have many different types of settlement statements and do not require the IRS-mandated information for the statements to be valid under state law. The IRS later found that not all states require complete addresses, and reversed this decision.<sup>34</sup> Now, for the settlement statement to be considered valid, it is not necessary for it (*i.e.*, HUD-1 Settlement Statement) to contain the buyer's and seller's signatures.<sup>35</sup>

**Example:** In Alaska, people often buy land with cash and build homes, which means there is no financing involved and no settlement statement. This type of case would fall under IRS math error authority, even though a taxpayer may have validly claimed the credit and could document the purchase and construction, but not in the

<sup>30</sup> Pub. L. No. 110-289. Congress revised the credit in the American Recovery and Reinvestment Act of 2009. This revision extended the FTHBC to purchases made on or after January 1, 2009, and before December 1, 2009; increased the maximum amount to \$8,000; and eliminated the repayment requirements as long as the taxpayer retains the residence for at least 36 months. Taxpayers qualifying for the revised credit may claim the \$8,000 on tax year 2008 or 2009 individual returns. Pub. L. No. 111-5, 123 Stat. 115 (2009).

<sup>31</sup> The credit was revised again in the Worker, Homeownership, and Business Assistance Act of 2009. Pub. L. No. 111-92, 123 Stat. 2984 (2009).

<sup>32</sup> IRC § 36(d)(4) requires the taxpayer to attach to his or her return a properly executed copy of the settlement statement.

<sup>33</sup> IRS, News Release, New Homebuyer Credit Form Released; Taxpayers Reminded to Attach Settlement Statements and Other Key Documents (Jan. 15, 2010), available at <http://www.irs.gov/newsroom/article/0,,id=218336,00.html> (last visited Nov. 2, 2011).

<sup>34</sup> IRS, IR-2010-006, <http://www.irs.gov/newsroom/article/0,,id=218336,00.html> (last visited Oct. 14, 2011). See also IRS SERP Alert 100290 (May 25, 2010).

<sup>35</sup> IRM 21.6.3.4.2.11.6 (6) (SERP update Apr. 18, 2011). See also IRS SERP Alert 100066 (Feb. 12, 2010). Mobile home purchasers may submit an executed retail sales contract including the names, address, purchase date and purchase price and signatures of both taxpayers if applicable. If the home was newly constructed, a copy of the occupancy permit is sufficient.

IRS-required form, and certainly not in a form that would easily be attached to an income tax return (*e.g.*, including copies of all receipts for lumber, plumbing, etc.).

These instances show that what at first may appear to be a clear-cut matter (*i.e.*, is documentation attached?) in fact has many variations. In these examples, the IRS is using math error authority to determine the *sufficiency* of documentation, in violation of Congress's original mandate that the IRS not use math error authority to resolve an uncertainty against the taxpayer.

### ***Math Error Provisions Should Be Narrowly Tailored.***

The National Taxpayer Advocate understands that a credit such as the FTHBC has substantial amounts of money at stake, making it attractive to individuals who want to abuse the system and get a quick, large refund for which they are not eligible.<sup>36</sup> The IRS uses math error authority as a low-cost way to protect revenue by preventing these returns from being processed and the refunds from going out. However, as noted above, failure to narrowly craft and implement math error provisions will harm taxpayers who are trying to comply with their tax obligations.<sup>37</sup>

Further, the continued expansion of math error authority into FTHBC-type facts-and-circumstances determinations could prevent eligible taxpayers from receiving a credit, undermine the policies for which the tax benefit was enacted, and cause a taxpayer to lose his or her right to dispute the IRS's determination in Tax Court.<sup>38</sup> In an effort to prevent these types of problems, where the IRS is seeking or Congress has enacted additional math error authority, the IRS should, as the GAO has recommended, develop a report to Congress in conjunction with the National Taxpayer Advocate on how math error authority expansion would meet the standards and criteria set forth by Congress and how it might impact taxpayer protections.<sup>39</sup> The National Taxpayer Advocate believes this report should be submitted to Congress at least six months before implementation of the proposed math error authority.<sup>40</sup>

<sup>36</sup> IRC § 36. See also TIGTA, Ref. No. 2011-40-128, *The Passage of Late Legislation and Incorrect Computer Programming Delayed Refunds for Some Taxpayers During the 2011 Filing Season* (Sept. 28, 2011).

<sup>37</sup> For an in-depth discussion of tax expenditures and the challenges of running social benefits through the Code, see National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 75 (*Running Social Programs Through the Tax System*) and National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 101 (*Evaluating the Administration of Tax Expenditures*).

<sup>38</sup> See Legislative Recommendation: *Mandate That the IRS, In Conjunction with the National Taxpayer Advocate, Review Any Proposed Expanded Math Error Authority to Protect Taxpayer Rights*, *infra*.

<sup>39</sup> GAO, GAO-11-691T, *Enhanced Prerefund Compliance Checks Could Yield Significant Benefits* (May 25, 2011). The National Taxpayer Advocate believes this report would be most effective if it was sent to Congress several months before implementation. If the provision has immediate effect, then the report should be submitted before the second filing season.

<sup>40</sup> See Legislative Recommendation: *Mandate That the IRS, In Conjunction with the National Taxpayer Advocate, Review Any Proposed Expanded Math Error Authority to Protect Taxpayer Rights*, *infra*.

## Current Problems with the Administration of Math Error Authority

### *Math Error Notices Are Still Confusing.*

The lack of clarity in math error notices makes it difficult for taxpayers to decide if they should accept the adjustment or request reversal.<sup>41</sup> For example, the IRS issued nearly 100,000 more self-employment tax math error notices in the first six months of calendar year (CY) 2011 than in CY 2010, but did so for reasons that the notice did not explain.<sup>42</sup> In many cases, the IRS mistakenly recomputed the tax without explanation, leaving taxpayers and preparers guessing why the IRS assessed additional tax.<sup>43</sup> Providing taxpayers with a clear explanation of why they are receiving the notice and what mathematical or clerical error has been identified helps make the process understandable so taxpayers can address the notice accordingly. The following example, taken from legislative history, demonstrates that in exchange for granting the IRS expanded math error authority, Congress expected the IRS to provide taxpayers with clear notice of the changes made to the return:

**Example:** A notice regarding an inconsistency in the number of dependents listed on the taxpayer's return might read as follows: "You entered six dependents on line x but listed a total of seven dependents on line y. We are using six. If there is one more, please provide corrected information."<sup>44</sup>

If notices are not simple and clear taxpayers cannot understand the rationale for the change to their returns, they may fail to request abatement within the 60-day period, thereby forfeiting their opportunity to contest the assessment in Tax Court and instead face IRS collection action.

The IRS has improved some math error notices, but others are still inadequate. TAS reviewed the verbiage included in more than 500 types of notices sent to taxpayers for problems with individual tax returns and found more than 40 inadequate explanations of IRS changes to the returns.<sup>45</sup> A common explanation given to taxpayers is that IRS adjusted the income reported on the return, without describing the item of income adjusted.

<sup>41</sup> A TAS study of math error notices conducted by Field Systemic Advocacy, Technical Analysis and Guidance, and Systemic Advocacy Systems (May 22, 2010) identified over 40 math error notice types for individual tax returns that lacked clarity or failed to explain taxpayer rights. Taxpayer Notice Codes (TPNC) may sometimes be referred to herein as math error notice types, identified by the notice number.

<sup>42</sup> IRS, IMF Math Error Reports 480-62-11 (July 2, 2011) and (July 3, 2010). By mid-2011 the IRS had issued 142,524 math error notices 268, increased from 43,841 at mid-2010.

<sup>43</sup> See Systemic Advocacy Management System (SAMS) Issues 20620 and 20973; IRS SERP Alert 110434 (June 10, 2011) (acknowledging the processing errors).

<sup>44</sup> H.R. Rep. No. 94-658, 94th Cong., 2nd Sess. (1976).

<sup>45</sup> TAS study of math error notices conducted by Field Systemic Advocacy, Technical Analysis and Guidance, and Systemic Advocacy Systems (May 22, 2010). Three different technical analysts reviewed more than 500 paragraphs of text explaining problems with the return, IRS changes, and actions required by taxpayers to resolve the problem on the individual tax return. Explanations were considered unclear if two of the three analysts found the passages confusing, inaccurate, incomplete, or expansive. This is a conservative estimate since the analysts who conducted the review have extensive experience with IRS documents and likely understood the notice more readily than an average taxpayer would. The group also reviewed 300 paragraphs for taxpayer notices relating to business returns and did not find any verbiage that multiple analysts thought was inadequate.

Easy-to-understand math error notices are essential, because taxpayers need to know what was changed so they can decide whether they agree, and, if not, what steps they should take.<sup>46</sup>

### ***The IRS Does Not Process Taxpayer Responses to Math Error Notices Timely or Accurately.***

Not only are some math error notices unclear and fail to explain why the taxpayer is receiving the notice and what to do next, but when taxpayers do understand the notices and respond, the IRS may not handle their responses timely or correctly. A TIGTA review of IRS processing such responses between January 1 and July 23, 2010, found that 40 percent (104 of 260) of the responses were not worked timely.<sup>47</sup> Based on this review, about 12,000 of 131,000 responses may not have been resolved timely during the specified period (January 1 to July 23, 2010).<sup>48</sup> These delays could result in taxpayers not receiving benefits timely. An untimely response rate will only increase the number of taxpayer calls to the IRS and potentially add to TAS's case inventory.

Additionally, in the same review TIGTA found that 43 of the 260 responses were not worked accurately. These errors resulted in the IRS paying about \$8,000 in erroneous refunds and incorrectly denying \$6,000 in benefits to taxpayers.<sup>49</sup> TIGTA estimated about 18,000 of 131,000 taxpayers may not have had their responses accurately resolved during this period. TIGTA further estimated that inaccuracies in resolving responses to math error notices could cost the federal government approximately \$39.5 million in lost revenue and cost taxpayers about \$29.2 million over the next five years. One possible explanation of this inaccuracy rate is the use of math error authority in more complex situations, such as the FTHBC examples illustrated above.

### **Math Error Authority May Not Always Be the Best Way to Resolve Cases.**

#### ***Third-Party Databases Are Not Always Reliable.***

Over the years, Congress has expanded math error authority to apply where comparison of tax return entries to information in non-IRS governmental databases indicates an error on the return. An appropriate example of this expanded authority is the use of the Social Security Administration's (SSA) NUMIDENT database.<sup>50</sup> Use of external data, a traditional audit indicator, is not justified for *summary* denial where the underlying database is inaccurate or incomplete or when reconciling the discrepancy involves the use of judgment or involves complex or evolving fact situations. For this reason, the National Taxpayer

<sup>46</sup> S. Rep. No. 938, 94th Cong., 2d Sess. 375 (1976); 1976-3 (Vol. 3) C.B. 49, 413.

<sup>47</sup> TIGTA, Ref. No. 2011-40-059, *Some Taxpayer Responses to Math Error Adjustments Were Not Worked Timely and Accurately* (July 7, 2011).

<sup>48</sup> *Id.* TIGTA estimated 12,232 of 130,616 responses may not have been timely resolved.

<sup>49</sup> *Id.* TIGTA estimated the IRS may not have accurately resolved 17,627 of 130,616 taxpayers' responses. TIGTA found IRS incorrectly denied \$5,894 in benefits and improperly paid \$7,988 to taxpayers.

<sup>50</sup> See IRM 2.3.32.8 (July 1, 2008); IRM 2.3.32.17 (Jan. 1, 2005). NUMIDENT information is a complete history of changes, such as name changes, as reported to SSA by the user of the SSA account number.

Advocate previously recommended repealing the use of the Federal Case Registry of Child Support Orders (FCR) under math error authority for summary assessment because this database does not accurately verify a child's residence.<sup>51</sup> This reasoning would apply equally to proposals to use certain state databases to determine eligibility, especially with respect to an individual's status as a qualifying child for EITC purposes, which is a complicated determination that requires an evaluation of facts-and-circumstances. Even if virtually all of the entries in a directory are accurate when entered, they were compiled for a different purpose, do not disprove eligibility under the tax law, were compiled at a prior date and may not be current, and should not deprive a taxpayer of a due process right to present his or her own facts. These databases would be used best as an indicator that the IRS should look more closely at the return in an examination — not math error — context.

***The IRS's Own Internal Records May Be More Useful for Checking Taxpayers' Returns.***

As mentioned above, the audit findings of GAO and TIGTA have called for increasing, not limiting, the use of math error authority.<sup>52</sup> But as discussed, this expansion may come at a high price, entailing increased complexity, confusion, inaccuracy, and burden. This is why it is imperative that the IRS move carefully when considering math error expansion.

Last year, the IRS addressed return processing errors, most of which are due to taxpayer mistakes in paper return preparation, by sending out 10.6 million math error notices.<sup>53</sup> However, by using its own internal records to glean specific information, such as TINs for dependents used on prior tax returns and Social Security numbers (SSNs) provided to the IRS by SSA,<sup>54</sup> and to analyze discrepancies between the taxpayer's return and third-party information, the IRS would reduce taxpayer burden, and potential IRS rework (*i.e.*, if the third-party information turns out to be inaccurate and the taxpayer disputes the summary assessment).

This internal research may be highly effective in preventing unnecessary math error adjustments and notices. For example, the IRS reversed about 50 percent of the math error disallowances of personal exemptions for dependent children in tax year 2006. TAS analyzed tax account data for 341,000 math errors issued in TY 2009 disallowing dependency exemptions and tax credits tied to dependents and found the IRS later reversed

<sup>51</sup> See National Taxpayer Advocate 2002 Annual Report to Congress 189 (Legislative Recommendation: *Math Error Authority*). Congress mandated that the IRS complete a study in conjunction with the National Taxpayer Advocate before implementing the use of the FCR; the study demonstrated that the FCR was unreliable and the IRS did not implement that math error authority. See IRS, Federal Case Registry Final Report, Project 5-02-12-3-005 (CR-39) (Sept. 2003). See also *Hearing on Improper Payments in the Administration of Refundable Tax Credits Before the Subcommittee on Oversight, Committee on Ways and Means* 26, 112th Cong. (May 25, 2011) (statement of Nina E. Olson, National Taxpayer Advocate).

<sup>52</sup> The IRS has established a task force to identify areas where the IRS could expand its use of math error authority. In this report, the National Taxpayer Advocate has made a legislative recommendation as to what type of expansions Congress should consider. See Legislative Recommendation: *Mandate That the IRS, In Conjunction with the National Taxpayer Advocate, Review Any Proposed Expanded Math Error Authority to Protect Taxpayer Rights*, *infra*.

<sup>53</sup> IRS, *IMF Math Error Report* (Dec. 24, 2010). The IRS issued 10,569,945 Individual Master File math error notices for TY 2009 returns.

<sup>54</sup> See IRM 2.3.1 (Jan. 1, 2008) for Integrated Data Retrieval System (IDRS) command code RTVUE.

184,000 — or about 55 percent — of the disallowances.<sup>55</sup> Further, a recent TAS study of a statistically valid sample of the same 184,000 reversals showed the IRS had internal data to immediately resolve 56 percent of those reversals, rather than deny the taxpayers their dependency exemptions and related tax credits and their tax refunds.

**FIGURE 1.4.2, TY 2009 Data Shows Opportunity for IRS to Resolve Incorrect Dependent TINs and Avoid Math Error Adjustments<sup>56</sup>**

| Sample Results Using Internal IRS Data  | Incorrect Dependent TINs, with credits other than EITC | Incorrect Dependent TINs with EITC | Total Incorrect Dependent TINs |
|---|--|------------------------------------|--------------------------------|
| Resolved All TINs Completely            | 51%  | 50%                                | 50%                            |
| Resolved Some TINs                      | 6%   | 5%                                 | 6%                             |
| Total Completely and Partially Resolved | 57%  | 55%                                | 56%                            |

This high abatement rate indicates that additional screening and internal research should be required before imposing on taxpayers the burdens of replying to the math error notices and waiting an average of 13.4 weeks for their refunds.<sup>57</sup>

The IRS should examine its math error abatement rates after each filing season to identify high abatement areas and then adjust procedures accordingly, considering alternatives such as not using math error authority or developing a pre-screening system using internal IRS information.

At the same time that the IRS requests additional math error authority to summarily deny tax benefits based on third-party information, it neglects to use readily available third-party information to resolve routine discrepancies such as incorrect or missing dependent TINs. Researching the accuracy of the information on a taxpayer’s return through internal records may help the IRS ensure that its math error assessments are correct and not used indiscriminately.<sup>58</sup>

<sup>55</sup> See National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, *infra* (Math Errors Committed on Individual Tax Returns: A Review of Math Errors Issued on Claimed Dependents). TAS Research (Sept. 2011). TAS analysis of TY 2006 and 2009 data from CDW IRTF and IMF (Dec. 2010). For tax year 2009 Notice Code 604 (missing TIN), 47 percent, or 36,000 of the notice assessments, were resolved fully or partially; for Notice Code 605 (incorrect TIN), 55 percent, or 114,000 were resolved fully or partially; and for Notice Code 743 (incorrect TIN for EITC), 61 percent, or 35,000 were resolved fully or partially. Although the IRS later reversed 47 percent of math errors with missing TIN data (Notice Code 604), these math errors are often associated with Individual Taxpayer Identification Number (ITIN) returns, and the IRS does not have the information needed to fill in missing TINs. Consequently, the analysis was narrowed to include only returns with math errors 605 or 743.

<sup>56</sup> See National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, *infra* (Math Errors Committed on Individual Tax Returns: A Review of Math Errors Issued on Claimed Dependents). TAS analysis of TY 2009 data from CDW IRTF and IMF (Oct. 2011). A sample of about 400 accounts in which the IRS abated its math error assessment showed that the IRS had internal data to resolve 56 percent of code 605 and 743 accounts. The column titled Incorrect Dependent TINs, with credits other than EITC reflects TPNC 605 accounts; the column titled Incorrect Dependent TINs with EITC reflects TPNC 743 accounts.

<sup>57</sup> TAS analysis of TY 2006 data from CDW IRTF and IMF (Dec. 2010). See also National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, *infra* (Math Errors Committed on Individual Tax Returns: A Review of Math Errors Issued on Claimed Dependents).

<sup>58</sup> The principal math error notices for disallowed dependent exemptions are TPNC 605 and 743.

***The Use of Math Error Authority Post-Processing Is Not a Revenue Protector.***

The IRS, in October 2010, instructed employees to disallow the FTHBC on taxpayers' TY 2008 returns, even though the refunds had already been processed and paid based on the original returns, because the purchase date entered on Form 5405, *First-Time Homebuyer Credit and the Repayment of the Credit*, for the identified returns fell outside the time for which the credit was available, and therefore was inconsistent with another item on the return (*i.e.*, the claiming of the credit).<sup>59</sup> However, it is not clear that this issue falls within math error authority.

The IRS relies on IRC § 6213(g)(2)(C), which refers to “an entry on a return of an item which is inconsistent with another entry of the same or another item on such return.” The IRS views the inconsistency as arising between the Form 1040 and Form 5405 (*i.e.*, it is inconsistent for the taxpayer to enter a date of purchase prior to April 8, 2008 on Form 5405, which would be before the credit is available, and then claim the credit on Form 1040). In the view of the National Taxpayer Advocate, it is uncertain that this explanation falls within IRC § 6213(g)(2)(C). Although the taxpayer does put the date of purchase on the Form 5405, nowhere on the face of the Form 1040 or Form 5405 is the taxpayer required to state that he or she has acquired a home during the eligible time periods. Thus, there is no item on the return that can create an inconsistency. A better way to ensure that the inconsistency clearly falls within math error authority would be for the IRS to ask on Form 5405 “Did you purchase your home within the eligibility period from x date to y date? (answer checkbox yes or no). If no, you are not eligible. If yes, enter date of purchase.” This example, answering yes on the form, but then entering an ineligible date, is clearly an inconsistent entry and would fall within IRC § 6213(g)(2)(C). *It is essential that the IRS make it clear to the taxpayer what it considers inconsistent, so if there is an inconsistency, it will be more likely to be a genuine mathematical or clerical error.*

Notably, in this situation, the IRS made these adjustments to taxpayer's returns “post-processing.” Thus, a taxpayer may be notified months or even years later that the IRS is making an assessment under its math error authority.<sup>60</sup> The IRS also used math error authority post-processing to assess additional tax on taxpayers who did not pay the FTHBC recapture amount.<sup>61</sup> Using math error authority in fact-specific situations may lead to improper assessments, such as in the following example:

**Example:** A taxpayer purchases a principal residence in May of 2008 and receives a \$7,500 FTHBC for tax year 2008, which generally will be repaid by imposing a \$500 increase in his tax liability for 15 taxable years beginning in 2010. In 2010, the taxpayer

<sup>59</sup> IRS SERP Alert 100512 (Oct. 6, 2010). After initially accepting the returns as filed the prior year, the IRS made math error post-processing adjustments determining that the date of purchase of the house listed on the Form 5405 was incorrect (*i.e.*, the date of purchase was before April 8, 2008).

<sup>60</sup> See *id.* This alert instructed IRS employees to use math error procedures when a taxpayer entered a purchase date on Form 5405 that was outside the time period for which the credit was available, and directed the FTHBC to be reversed using math error procedures if the taxpayer did not respond with documentation showing a qualified purchase date.

<sup>61</sup> IRS SERP Alert 110515 (July 25, 2011) (announcing that the \$500 FTHBC recapture will be automatically assessed on some accounts).

sells the house at a loss, which means he is not required to pay any further recapture amount,<sup>62</sup> but he does not file Form 5405 with his 2010 tax return to report the loss on the sale. Therefore, through its math error authority under IRC § 6213(g)(2)(P), the IRS retroactively (*i.e.*, after issuing the full refund shown on the return) makes a summary assessment for omitting the recapture payment, even though no such payment was required. The taxpayer then faces the burden of explaining the facts and circumstances of his situation to avoid math error assessments for multiple years.

This example illustrates how difficult it is to apply math error authority to a facts-and-circumstances situation and the harm that can come to the taxpayer (*i.e.*, a summary assessment on a credit already received). Using math error authority this way (after processing a taxpayer's return) confuses taxpayers and may not achieve the IRS's desired result of revenue protection. Deficiency procedures may be more effective in these situations and give the taxpayer at least 90 days, as opposed to 60 days, to gather documents and communicate with the IRS. Especially where time has elapsed since the filing of the return, it makes sense to grant taxpayers that additional time.

Math error authority was designed to streamline IRS processing for simple mistakes, and was created *before* there were significant refundable credits, such as the FTHBC. However, with the growth of these credits, math error authority has also become important as a revenue protection strategy. Applying math error authority post-processing does little to protect revenue because the IRS has already paid the refund based on the original return. The confusion caused by such an adjustment after the return has been processed can cause a good deal of IRS rework and taxpayer burden.

## CONCLUSION

Tax return changes designated as math errors carry significant consequences that can harm taxpayer rights. It is therefore essential that the IRS proceed carefully before using this broad authority. Rather than issuing math error notices whenever it is authorized to do so, the IRS should carefully consider its ability to address the error through its own research. Additionally, several math error notices remain unclear. The expansion of math error authority adds complexity to the notices, confuses taxpayers, and may result in their failing to protest the assessments and losing their appeal rights. For these reasons, it is imperative that the IRS carefully consider all other means of correcting the error before exercising its authority. It should make sure that math error notices, and the process for contesting assessments, are clear.

The National Taxpayer Advocate preliminarily recommends that the IRS:

1. Direct employees to conduct internal research to resolve clerical errors, such as incorrect entries of the dependents' TINs or surnames.

<sup>62</sup> IRC § 36(f)(3).

2. Examine math error abatement rates after each filing season to identify high abatement areas and adjust procedures accordingly, including avoiding use of math error authority or developing a pre-screening system using internal IRS information.
3. Revise the descriptive paragraphs (TPNCs) in math error notices to identify precisely the reason for a tax return change and which entries are inconsistent.
4. Conduct a study in collaboration 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 through existing data.

### IRS COMMENTS

Math error authority under § 6213 of the Internal Revenue Code provides the IRS with a valuable tool to address mathematical or clerical errors on tax returns in appropriate cases. It allows the IRS to adjust the tax return to reflect the correct tax liability without referring the case to Examination for a resource-intensive audit of the return. Over the years, Congress has incrementally expanded the authority to allow the IRS to automatically correct returns for additional types of mathematical or clerical errors, including instances where the IRS receives reliable third party information. This authority has enabled the IRS to effectively and efficiently adjust returns and stop erroneous refunds from being issued. The IRS recognizes that taxpayer rights are an important consideration in the use of math error authority.

The IRS appreciates the National Taxpayer Advocate's acknowledgment that math error authority can be an effective processing tool. In those instances where math error authority is available, taxpayer errors can be addressed quickly, resulting in less burden and faster refunds to taxpayers as compared to an examination. In addition nearly all returns with similar errors can be treated consistently, thus creating equity between compliant and noncompliant taxpayers. Math error authority is also used to help ensure eligible taxpayers receive tax benefits they underclaimed. Lastly, the IRS is able to use costly Examination resources that would otherwise be spent on math errors to pursue other forms of noncompliance that require facts and circumstances based determinations.

The IRS agrees that the expansion of math error authority should be considered carefully taking into account taxpayer rights issues. The GAO, in its report to Congress dated February 2010, reported that the IRS could benefit from broader math error authority. We are exploring whether there are opportunities for additional authority that would improve tax administration without impacting taxpayer rights. Due to technical advances and increased access to reliable data, the IRS is able to collect information from various sources to verify entries on taxpayers' returns. Even when information in the IRS's possession indicates that a taxpayer's return contains an error, without specific math error authority the IRS cannot adjust the tax return during processing to reflect the correct tax liability. We continue to work with the National Taxpayer Advocate in this effort and will continue

to recognize the importance of respecting taxpayer rights, including assuring that information used in a math error determination is accurate and reliable.

The IRS disagrees with the National Taxpayer Advocate's assertion that the math error program creates significant burden or hardship to taxpayers. The IRS provides taxpayers with their rights provided by law, including administrative appeal and judicial review. The IRS sends a notice to the taxpayer identifying the alleged error with an explanation. The notice also informs the taxpayer that the taxpayer has 60 days to request the IRS abate the assessment. If the taxpayer disagrees with the assessment and requests an abatement of this amount, the IRS is required to abate the tax. If the IRS determines that the deficiency should be assessed, it then follows deficiency procedures that afford the taxpayer additional time to address the issue and the opportunity to obtain judicial review before the tax is reassessed and paid.

With respect to IRS notices, the IRS shares the National Taxpayer Advocate's interest in developing plain language effective notices that help taxpayers take the appropriate action to resolve their tax issues. The IRS received top honors, the Grand ClearMark Award, for the clearest language on notices such as the Additional Child Tax Credit. The IRS continues to review and rewrite notices in plain language. Two redesigned math error notices, CP10 and CP11, went into production in July 2010. Three more, CP12, CP13, and CP16 went into production in January 2011. With the redesign, the IRS incorporated plain language that is easier for the taxpayer to understand and added line numbers from the tax form to assist taxpayers in locating the errors on their own return. We are working with Research to determine effectiveness of the redesigned notices, and will make additional changes based on those results.

The IRS agrees there was an increase in math error notices in 2010 compared to 2005. The increase was primarily due to the Making Work Pay Credit. This credit accounts for 5.6 million of the 10.6 million math error notices issued in 2010. Eighty-five percent of the notices for the MWP credit informed the taxpayer that the IRS had figured the credit for them (because the taxpayer failed to claim the credit). Historically, the error rate and number of notices rise sharply whenever the IRS offers to calculate a credit for taxpayers. The credit was in effect for tax year 2009 and 2010. In 2010, the IRS sent five million math error notices, adjusted for MWP, compared to four million in 2005. Per TIGTA report 2011-40-059, more than 98 percent of the individuals receiving a math error notice between January 1 and July 23, 2010, agreed with the adjustments made to their tax returns.

With respect to the recommendations in the draft report, we note the following:

With respect to the recommendation to direct employees to conduct internal research to resolve errors, the Internal Revenue Manual directs IRS employees to conduct internal research to resolve clerical errors with taxpayer TINs during the processing of math or clerical errors (referred to as math errors). Employees are also instructed to search the return and attachments for dependent TINs. If the information is found during internal research

or from information on the return and attachments, the IRS will perfect the clerical error. If the IRS is unable to perfect the clerical error, a math error notice is issued to the taxpayer explaining the error(s) identified and the amount of any resulting adjustment(s).

An analysis of all math error notice data from four cycles in 2010 (one cycle per quarter) shows an overall reversal rate of 13 percent. The IRS agrees to perform additional analysis to review the data by type of math error to determine whether procedures may need to be adjusted. It should be noted that the top four Taxpayer Notice Codes (TPNCs) in this analysis related to the MWP credit and account for 77.4 percent of the math error notices with the reversal rate for all four being lower than the average.

With respect to notices, although we cannot tailor language to each individual taxpayer's situation, we agree that notices should be clear and understandable to taxpayers. The Return Integrity and Correspondence Services office will continue to review and rewrite notices using plain language.

In addition, the IRS will continue to collaborate cross functionally as we consider potential opportunities for new math error authority. We look forward to continuing work with the National Taxpayer Advocate in this effort.

### Taxpayer Advocate Service Comments

The National Taxpayer Advocate agrees that math error authority can be an effective processing tool when used appropriately (*i.e.*, not in situations that require a facts-and-circumstances determination or reliance on unreliable third-party data). The National Taxpayer Advocate further agrees that expansion of math error authority is appropriate in certain limited circumstances and can reduce IRS costs and taxpayer burden.<sup>63</sup> We commend the IRS for making some progress in improving the clarity of math error notices and are pleased that the IRS has offered to work with the National Taxpayer Advocate as the IRS determines what type of expansions are appropriate. This sort of collaboration has not occurred in the recent past, so we welcome the opportunity to work with the IRS and have our concerns addressed before proposals are set in stone.

#### **Inappropriate Use of Math Error Authority Can Cause Taxpayer Burden and Hardship.**

The National Taxpayer Advocate disagrees with the IRS statement that math error authority does not increase taxpayer burden or hardship, because the inappropriate use of this authority can produce exactly that effect. For example, using math error authority to include review of the documentation for the FTHBC has caused problems for both the IRS and taxpayers. In fact, having the IRS determine whether a taxpayer had attached a properly

<sup>63</sup> For a discussion regarding the types of math error expansion the National Taxpayer Advocate agrees with, see Legislative Recommendation: *Mandate that the IRS, in Conjunction with the National Taxpayer Advocate, Review Any Proposed Expanded Math Error Authority to Protect Taxpayer Rights, infra.*

executed settlement statement proved difficult, particularly in states that did not require the same information on the statement as the IRS. This put the IRS in the position of imposing its own judgment for that of the taxpayer, which is precisely the type of determination Congress found inappropriate for math error authority. Making a math error adjustment based on this judgment creates more IRS re-work by requiring the taxpayer to contact the IRS and then provide the necessary documentation before the IRS can finally issue the refund. As discussed, this process alone can take an average of 13.4 weeks.<sup>64</sup> Additionally, using any math error authority to make this type of judgment risks the taxpayer losing his or her right to go to Tax Court and dispute the IRS determination. In these fact-specific situations, deficiency procedures may be more effective and provide the taxpayer at least 90 days, as opposed to 60 days, to gather documents and communicate with the IRS.

#### **Information from Third-Party Sources to Verify a Taxpayer's Return Must Be Reliable.**

The National Taxpayer Advocate agrees that expansion of math error authority may be appropriate where reliable, accurate third-party information is available to verify the information on a taxpayer's return. The real issue then becomes: what is reliable information? As noted above, one example of reliable external data is the SSA NUMIDENT database.<sup>65</sup> Conversely, the Federal Child Support Registry is an example of an unreliable database that was compiled for a different purpose entirely and should not be used to make summary denials. This is why the National Taxpayer Advocate agrees with the GAO's recommendation that where the IRS is seeking (or Congress has enacted) additional math error authority, the IRS and the National Taxpayer Advocate should report to Congress on how the expansion would meet the standards and criteria set forth by Congress and might impact taxpayer protections.<sup>66</sup>

#### **Math Error Notice Clarity Is Critical.**

The National Taxpayer Advocate commends the IRS for its continued efforts to provide taxpayers with clear, easy-to-understand notices. She is encouraged that the IRS has recently taken steps to improve some math error notices and hopes this effort continues with TAS playing a role. It is essential that the IRS provide clear, simple notices so taxpayers can understand the rationale for the changes to their returns and their right to request abatement within 60 days, preserving their opportunity to contest the adjustment in Tax Court.

#### **The Number of Math Error Notices Sent to Taxpayers Has Recently Increased.**

The National Taxpayer Advocate understands that a significant portion of the increase in math error notices is the result of Congress granting the IRS new math error authority,

<sup>64</sup> TAS analysis of TY 2006 data from CDW IRTF and IMF (Dec. 2010). See also National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, *infra*.

<sup>65</sup> See IRM 2.3.32.8 (July 1, 2008); IRM 2.3.32.17 (Jan. 1, 2005). NUMIDENT information is a complete history of changes, such as name changes, as reported to SSA by the user of the SSA account number.

<sup>66</sup> GAO, GAO-11-691T, *Enhanced Prerefund Compliance Checks Could Yield Significant Benefits* (May 25, 2011). The National Taxpayer Advocate believes this report would be most effective if it was sent to Congress several months before implementation. If the provision has immediate effect, then the report should be submitted before the second filing season.

such as the Making Work Pay credit and the FTHBC.<sup>67</sup> However, it may not be appropriate to use math error authority where the IRS is disbursing tax credits. In the legislative recommendation section of this report, the National Taxpayer Advocate provides criteria to be considered to determine if using math error in these circumstances is appropriate.<sup>68</sup>

The TIGTA report referenced in the IRS response proclaims that more than 98 percent of the individuals receiving a math error notice between January 1 and July 23, 2010, agreed with the adjustments to their returns.<sup>69</sup> However, this figure includes taxpayers who received a math error notice and did not respond to the notice within the 60-day timeframe. The National Taxpayer Advocate does not believe that the lack of a response from the taxpayer regarding the math error notice can be equated to an agreement as to the adjustment. In fact, there may be a number of reasons why the taxpayer did not respond (e.g., he or she did not understand the notice). Further, the report most certainly does not mean that the adjustments were right. For example, as described in Volume 2, *Math Errors Committed on Individual Tax Returns: A Review of Math Errors Issued on Claimed Dependents*, of this report, TAS analyzed tax account data for 341,000 math errors issued in TY 2009, disallowing dependency exemptions and tax credits tied to dependents and found the IRS later reversed 184,000 — or about 55 percent — of the disallowances.<sup>70</sup>

#### **IRS Internal Research to Fix Taxpayer Errors Does Not Go Far Enough.**

Although IRS employees are instructed to conduct internal research to correct taxpayer mistakes, this only includes checking the return and any attached documents.<sup>71</sup> TAS proposes that the IRS use internal records such as TINs for dependents used on prior tax returns and SSNs provided by SSA.<sup>72</sup> In other words, the IRS should use the same information to fix taxpayer errors as it does to make math error adjustments. In the TAS research study mentioned above, a statistically valid sample of the 184,000 reversed disallowances showed the IRS had internal data to immediately resolve 56 percent of those reversals, rather than deny the taxpayers their exemptions, credits, and refunds. Revising IRS procedures to require more internal research could prevent many unnecessary math error notices from being sent to taxpayers.

<sup>67</sup> IRC §§ 36A and 36.

<sup>68</sup> See Legislative Recommendation: *Mandate that the IRS, in Conjunction with the National Taxpayer Advocate, Review Any Proposed Expanded Math Error Authority to Protect Taxpayer Rights*, *infra*.

<sup>69</sup> TIGTA, Ref. No. 2011-40-059, *Some Taxpayer Responses to Math Error Adjustments Were Not Worked Timely and Accurately* (July 7, 2011).

<sup>70</sup> See National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, *infra* (*Math Errors Committed on Individual Tax Returns: A Review of Math Errors Issued on Claimed Dependents*). TAS analysis of TY 2006 and 2009 data from CDW IRTF and IMF (Dec. 2010). For tax year 2009, Notice Code 604 (missing TIN), 47 percent, or 36,000 of the notice assessments were resolved fully or partially; for Notice Code 605 (incorrect TIN), 55 percent, or 114,000 were resolved fully or partially; and for Notice Code 743 (incorrect TIN for EITC), 61 percent, or 35,000 were resolved fully or partially. Although the IRS later reversed 47 percent of math errors with missing TIN data (Notice Code 604), these math errors are often associated with ITIN returns, and the IRS does not have the information needed to fill in missing TINs. Consequently, the analysis was narrowed to include only returns with math errors 605 or 743.

<sup>71</sup> IRM 3.12.3.4.3.18 (Jan. 1, 2011).

<sup>72</sup> See IRM 2.3.1 (Jan. 1, 2008) for IDRS command code RTVUE.

In regard to the math error adjustments that the IRS does abate, the National Taxpayer Advocate is pleased that the IRS has agreed to examine its abatement rates after each filing season to identify high abatement areas and change its procedures accordingly.

## Recommendations

The National Taxpayer Advocate recommends that the IRS:

1. Direct employees to conduct internal research to resolve clerical errors, including incorrect entries of the dependents' TINs or surnames.
2. Examine math error abatement rates after each filing season to identify high abatement areas and adjust procedures accordingly, including avoiding the use of math error authority and developing a pre-screening system using internal IRS information to minimize improper math error adjustments.
3. Revise the descriptive paragraphs (TPNCs) in math error notices to identify precisely the reason for a tax return change and which entries are inconsistent.
4. Conduct a study in collaboration 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 through existing data.

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## 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

### RESPONSIBLE OFFICIALS

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

### DEFINITION OF PROBLEM

The IRS’s wholesale use of automated “enforcement assessments” has increased dramatically over the past decade, placing a considerable drain on IRS Collection resources with questionable benefits for revenue collection and tax compliance.<sup>1</sup> These automated processes do not emphasize personal contact with the affected taxpayers; in fact, the IRS’s methods of contacting these taxpayers may discourage communication rather than promote productive responses and timely case resolutions. While the basic operating premise of the Automated Substitute for Return (ASFR) program holds that substantially inflated proposed assessments will drive taxpayers to file the delinquent returns, 83 percent of ASFR returns in fiscal year (FY) 2010 were “defaulted” assessments, (*i.e.*, the taxpayers did not respond or otherwise agree with the proposed amounts).<sup>2</sup> Further, 76 percent of the tax dollars applied to ASFR assessments from FY 2006 through FY 2010 were actually “pre-paid credits” (*i.e.*, withholding credits, estimated tax payments, or other payments credited to the taxpayers’ accounts *prior to the due dates of the returns*).<sup>3</sup>

The high volumes of automated “enforcement assessments” have substantially inflated the IRS’s inventory of Collection accounts receivable, although IRS data indicate the majority of these assessments are ultimately abated or reported as uncollectible.

- By FY 2011, the number of returns generated by the Automated Substitute for Return process had increased by 896 percent as compared with the number assessed in FY 2002.<sup>4</sup>
- As of March 2011, automated “enforcement assessments” accounted for 43 percent of the IRS’s potentially collectible accounts receivable.<sup>5</sup>

<sup>1</sup> In this report, the term “enforcement assessments” refers to the Automated Substitute for Return (ASFR) program, which establishes tax liabilities in situations involving individual income tax return delinquencies.

<sup>2</sup> IRS response to TAS information request (July 13, 2011).

<sup>3</sup> *Id.* Data provided by the IRS from the Enforcement Revenue Information System (ERIS) database on the Compliance Data Warehouse.

<sup>4</sup> IRS, Collection Activity Report, NO-5000-139, *National Delinquent Return Activity Report* (2002–2011).

<sup>5</sup> Data provided by the Chief Financial Officer (CFO) to the Collection Governance Council (Apr. 13, 2011). The IRS Potentially Collectible Inventory (PCI) is a subset of the IRS inventory of unpaid assessments. The IRS has determined the PCI to be cases with the most potential for successful resolution with collection resources.

- In FY 2011, the IRS abated 2.4 times as many ASFR Taxpayer Delinquent Account (TDA) dollars as it collected (including refund offsets), and reported as currently not collectible (CNC) approximately four times the amount collected.<sup>6</sup>
- From FY 2006 through FY 2011, the IRS collected less than ten percent of the TDA dollars established through the ASFR process.<sup>7</sup>

The high volume of automated enforcement assessments clogs the collection process with unproductive work, and wastes resources that the IRS could otherwise invest in more worthwhile areas (*e.g.*, outgoing calls to taxpayers by the Automated Collection System (ACS) and expanded use of the offer in compromise (OIC) program). Further, the raw numbers of these assessments have distorted the composition of the IRS’s Collection inventory in a manner that diverts Collection resources from cases that may be more collectible and tax assessments that are significantly more valid.

## ANALYSIS OF PROBLEM

### **Automated “enforcement assessments” are key tools for enforcing filing compliance.**

ASFR is the key program for enforcing filing compliance by taxpayers who have not filed individual tax returns, but have incurred a “significant” tax liability.<sup>8</sup> The program estimates the liability by computing tax, penalties, and interest based upon information reported to the IRS by third-party payers.<sup>9</sup> When a taxpayer with reported income is delinquent in filing a return, the IRS attempts to secure the return through correspondence. If the attempt is unsuccessful, the IRS is authorized by the Internal Revenue Code (IRC) to prepare a substitute return for the taxpayer.<sup>10</sup>

Generally, a return delinquency meets ASFR criteria when income information obtained through the IRS Information Return Program is available for the delinquent tax module, the module is no older than five years prior to the current processing year, there are no related TDAs, and the proposed tax liability is over a certain dollar threshold.<sup>11</sup> When the IRS selects a return delinquency for ASFR processing, the program calculates an estimated tax liability based on available income information with an assumed filing status of “single” or “married filing separate” with one exemption. Generally, this proposed liability exceeds

<sup>6</sup> IRS, Collection Activity Report, NO-5000-242, *Type of Assessment Reports* (Oct. 2011).

<sup>7</sup> IRS, Collection Activity Report, NO-5000-242, *Type of Assessment Reports* (2007 - 2011).

<sup>8</sup> Internal Revenue Manual (IRM) 5.18.1.2 (May 1, 2005). To meet ASFR processing criteria, the proposed tax liability must meet or exceed a predetermined dollar threshold established by the IRS for the ASFR program. Currently, the ASFR threshold is substantially lower than the dollar amount used to determine TDA issuance criteria.

<sup>9</sup> IRM 5.18.1.2 (May 1, 2005). The IRS can use information returns (*e.g.*, Forms W-2 and 1099) filed by employers, banks, and other third parties to report various types of payments to individuals. These payments include wages, interest, and dividends, as well as payments to self-employed taxpayers for services rendered. The IRS collects and maintains this information through the Information Return Program (IRP).

<sup>10</sup> IRC § 6020(b).

<sup>11</sup> IRM 5.18.1.3.1 (Jan. 28, 2010).

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what the taxpayer actually would owe on a self-reported return.<sup>12</sup> The IRS notifies the taxpayer of the proposed assessment via a “30-day letter.”<sup>13</sup> The taxpayer may respond with an original return, an agreement to the proposed ASFR assessment, or a statement indicating disagreement with the assessment. If the taxpayer disagrees or fails to resolve the return delinquency during this 30-day period, the IRS sends a Statutory Notice of Deficiency (90-day letter) to the taxpayer by certified mail.<sup>14</sup> If the taxpayer does not resolve the return delinquency or petition the Tax Court for relief within 90 days, the ASFR program assesses the proposed tax, penalties and interest, and collection action proceeds on any unpaid balance due.<sup>15</sup>

**Internal and external reviews raise questions about the overall benefits of the ASFR program.**

The ASFR program has been analyzed extensively since it began in 1988. Several of these studies have been critical of the program, raising particular concerns about the impact of high volumes of ASFR assessments on the IRS’s inventory of delinquent accounts receivable, the collectibility of ASFR assessments, and the increased taxpayer burden created by the ASFR process.

For example, as early as 1991, the IRS determined that “only a small percentage of the (ASFR) dollars and modules are collected during the assessment process and notice routine. More should be done in determining collectibility prior to making the (ASFR) assessment and in collecting the liability prior to and while in notice status.”<sup>16</sup> Another IRS analysis completed in 1998 concluded:

The IRS needs to place much greater emphasis on establishing contact with the taxpayers represented in the ASFR inventory, obtaining ‘agreed’ assessments for the tax years in question, and resolving all aspects of the taxpayers’ delinquency problems, including collection, through one stop service.<sup>17</sup>

The GAO made the following observation in 1995: “The establishment of a receivable as a result of an IRS compliance effort which overstates a taxpayer’s liability makes additional

<sup>12</sup> General Accounting Office (GAO, now the Government Accountability Office), GAO/GGD-00-60R, *IRS’ Substitute for Returns* 8 (Feb. 2000). In this report, the GAO observes, “According to IRS officials, the “married filing separately” status is used because only the taxpayer can claim the “married filing jointly” status. Also, the “married filing separately” status is to encourage the potential nonfilers to file a correct return if they can claim the “married filing jointly” status.” Further, “IRS also does not use information from the taxpayer’s most recent tax return. This information includes marital status and dependent data. However, the IRS has no assurance that this information is accurate for the current tax year.”

<sup>13</sup> IRM 5.18.1.7.5 (Jan. 28, 2010). The ASFR “30-day letter” provides the taxpayer with the proposed assessment amounts, and gives the taxpayer 30 days to respond. At the conclusion of the 30-day letter suspense period, if there is no/insufficient response, ASFR generates a Statutory Notice of Deficiency (90-day letter).

<sup>14</sup> IRM 5.18.1.7.6 (Oct. 1, 2005). The ASFR “90-day letter” (i.e., the statutory notice of deficiency) notifies the taxpayer that a deficiency has been established, and instructs the taxpayer on how to petition the Tax Court to contest the determination.

<sup>15</sup> IRM 5.18.1 (Apr. 20, 2010).

<sup>16</sup> IRS, *Currently Not Collectible Study Group Report* 82 (Feb. 1991).

<sup>17</sup> IRS, *Automated Substitute for Return (An Analysis from the Customer’s Perspective)* 3 (Nov. 1998).

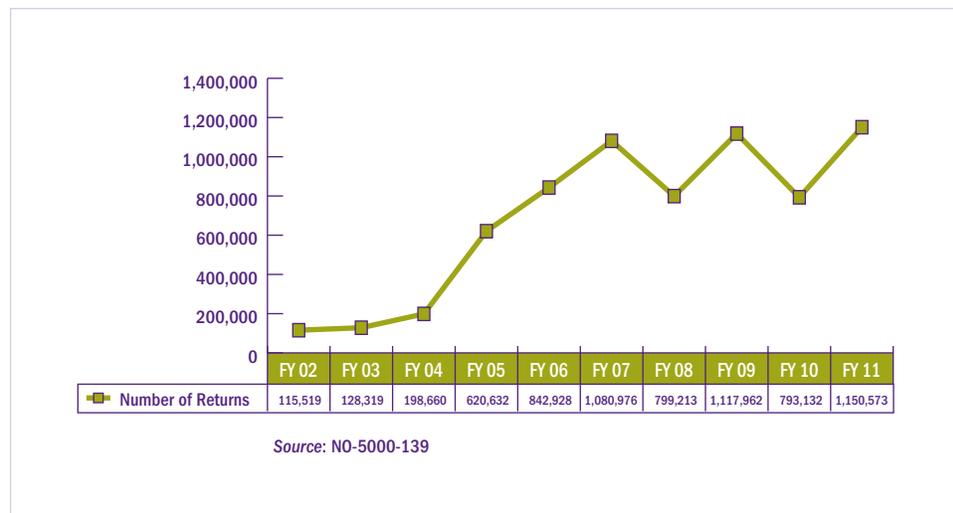
work for collection personnel with no guarantee of revenue generation.”<sup>18</sup> In the same report, GAO commented that high levels of dollar abatements indicated, “a significant portion of the accounts receivable inventory should not have been established in the first place.”<sup>19</sup>

In the 2007 Annual Report to Congress, the National Taxpayer Advocate reported similar concerns with the ASFR program’s “high default assessments, low collection percentages, and significant downstream consequences in the form of TAS casework.”<sup>20</sup> This report identified a need to improve the automated selection process to reduce taxpayer burden, and recommended enhanced customer service options such as telephone contacts prior to finalizing assessments to resolve more ASFR cases early in the process.

**The “bulk processing” of automated enforcement assessments continues to produce questionable benefits in the area of revenue collection.**

Despite the concerns with “enforcement assessments” dating back to 1991, these problems remain evident in current ASFR program results. Enforcement assessments are inflating the IRS’s inventory of delinquent accounts receivable to unprecedented levels. By FY 2011, the number of ASFR-generated returns increased by 896 percent of the number assessed in FY 2002 (see Figure 1.5.1).<sup>21</sup> As of March 2011, ASFR assessments accounted for 43 percent of the IRS’s potentially collectible accounts receivable.<sup>22</sup> At the end of FY 2011, 36 percent of all TDA dollars in open inventory involving individual tax returns (Individual Master File or IMF) were associated with ASFR assessments.<sup>23</sup>

**FIGURE 1.5.1 ASFR ASSESSMENTS (2002-2011)**



<sup>18</sup> GAO, GAO/HR-95-6, *Internal Revenue Service Receivables* 15 (Feb. 1995).

<sup>19</sup> *Id.*

<sup>20</sup> National Taxpayer Advocate 2007 Annual Report to Congress 246.

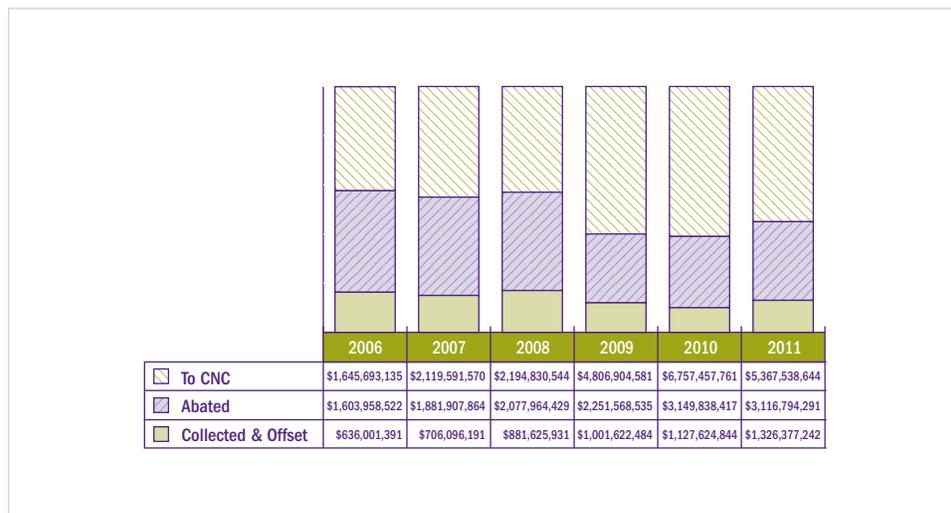
<sup>21</sup> IRS, Collection Activity Report, NO-5000-139, *National Delinquent Return Activity Report (2002 - 2011)*.

<sup>22</sup> Data provided by the CFO to the Collection Governance Council (Apr. 13, 2011).

<sup>23</sup> IRS, Collection Activity Report, NO-5000-242, *Type of Assessment Reports* (Oct. 2011).

The IRS actually collected less than ten percent of the TDA dollars established through the ASFR process from FY 2006 through FY 2011.<sup>24</sup> Moreover, the IRS abates or reports as currently not collectible increasingly high percentages of these accounts (see Figure 1.5.2). In FY 2011, while collecting approximately \$1.3 billion on ASFR TDA accounts (including \$499 million in refund offsets), the IRS reported \$5.4 billion as CNC, and abated another \$3.1 billion.<sup>25</sup> The dollar value of ASFR TDAs reported as uncollectible has increased by 226 percent from FY 2006 to 2011,<sup>26</sup> while the ASFR dollars abated increased by 94 percent.<sup>27</sup>

**FIGURE 1.5.2, ASFR Program Results (2006 - 2011)**



While the basic operating premise of the ASFR program holds that substantially inflated proposed assessments will drive taxpayers to file the delinquent returns, 83 percent of ASFR returns in FY 2010 were “defaulted” assessments (*i.e.*, the taxpayers did not respond or otherwise agree with the proposed amounts).<sup>28</sup> Moreover, IRS data indicate that in ASFR cases closed from FY 2006 through FY 2010, only 2.5 percent of the assessed dollars (excluding interest and penalties) were collected through collection notices, and 2.8 percent were collected by the Automated Collection System (ACS).<sup>29</sup> However, 39 percent of open ASFR TDAs were assigned to the Collection Queue at the end of FY 2011, where they could remain inactive for years.<sup>30</sup> Even more noteworthy is that 76 percent of the tax dollars

<sup>24</sup> IRS, Collection Activity Report, NO-5000-242, *Type of Assessment Reports* (2007 - 2011).

<sup>25</sup> IRS, Collection Activity Report, NO-5000-242, *Type of Assessment Reports* (Oct. 2011).

<sup>26</sup> IRS, Collection Activity Report, NO-5000-242, *Type of Assessment Reports* (2007 - 2011).

<sup>27</sup> *Id.*

<sup>28</sup> IRS response to TAS information request (July 13, 2011).

<sup>29</sup> *Id.* Data provided by the IRS from the Enforcement Revenue Information System (ERIS) database on the Compliance Data Warehouse.

<sup>30</sup> IRS, Collection Activity Report, NO-5000-242, *Type of Assessment Reports* (Oct. 2011). The Collection Queue is an automated inventory where active but unassigned collection cases reside until IRS resources are available to work them, or they are otherwise systemically reported as currently not collectible.

applied to ASFR assessments from FY 2006 through FY 2010 were actually “pre-paid credits” (*i.e.*, withholding credits, estimated tax payments, or other payments credited to the taxpayers’ accounts *prior to the due dates of the returns*).<sup>31</sup> These results raise serious questions about the overall effectiveness and efficiency of the ASFR process, the program’s impact on the non-filer population, and the validity of the program’s operating assumptions of taxpayer behavior.

**Automated “enforcement assessments” sacrifice taxpayer service for processing efficiencies.**

Prior studies have reported that the IRS frequently establishes “enforcement assessments” for taxpayers under old and incorrect addresses.<sup>32</sup> The ASFR process will generate assessments even when notices have been returned as undeliverable or unclaimed.<sup>33</sup> Yet, the IRS concluded in a 1998 analysis that the time lag between the due date of the tax return and the proposed ASFR assessment contributes to a high volume of cases where taxpayers may not have received *any* actual notice of the ASFR assessment process.<sup>34</sup> In 1999, after this study, the IRS stopped establishing ASFR assessments in cases without a confirmed address. However, in March 2004, the IRS determined that postal tracer checks (*i.e.*, using Form 4759, *Postal Tracer*, to confirm with local post offices the validity of individual taxpayer addresses) were “redundant” and eliminated this safeguard from the ASFR process to reduce cycle time.<sup>35</sup> Subsequently, in FY 2005 the number of ASFR assessments was 484 percent of the figure for FY 2003!<sup>36</sup>

In recent years, identity theft has emerged as a very serious problem.<sup>37</sup> The decision to eliminate the “confirmed address” safeguard does not appear prudent or responsible, considering the potential impact of identity theft in “no response” ASFR cases, and the need for the IRS to ensure the information used as the basis for ASFR assessments is valid for the affected taxpayers. The IRS does not even track the number of ASFR notices returned as undeliverable or unclaimed.<sup>38</sup> In 1998, an IRS study revealed that from FY 1994 through

<sup>31</sup> IRS response to TAS information request (July 13, 2011). Data provided by the IRS from the Enforcement Revenue Information System (ERIS) database on the Compliance Data Warehouse.

<sup>32</sup> IRS, *Currently Not Collectible Study Group Report* 80 (Feb. 1991). This study concluded that the “currentness (sic) of a taxpayer’s address has a significant impact on collectibility of an assessment, and approximately 30 percent of all SFR 30-day letters are returned undeliverable.” See also, IRS, *Automated Substitute for Return (An Analysis from the Customer’s Perspective)* 4 (Nov. 1998). This study concluded that a high percentage of ASFR assessments are made in situations where the taxpayers have not received notice of the proposed deficiencies. “We estimate approximately 50 percent of ASFR assessments fall into this category.”

<sup>33</sup> For a detailed discussion of the IRS’s problems with undelivered mail, see National Taxpayer Advocate 2010 Annual Report to Congress (Most Serious Problem: *The IRS Has Not Studied or Addressed the Impact of the Large Volume of Undelivered Mail on Taxpayers*).

<sup>34</sup> IRS, *Automated Substitute for Return (An Analysis from the Customer’s Perspective)* 4 (Nov. 1998).

<sup>35</sup> Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2005-30-073, *The Small Business/Self-Employed Division Has Made Significant Changes to Enhance the Automated Substitute for Return Program, but Opportunities Exist for Further Improvement* 7 (Apr. 2005).

<sup>36</sup> IRS, Collection Activity Report, NO-5000-139, *National Delinquent Return Activity Report* (2003 - 2005).

<sup>37</sup> For a discussion of the impact of identity theft on IRS operations, see National Taxpayer Advocate 2008 Annual Report to Congress (Most Serious Problem: *IRS Process Improvements to Assist Victims of Identity Theft*); see also National Taxpayer Advocate 2009 Annual Report to Congress (Status Update: *IRS’s Identity Theft Procedures Require Fine-Tuning*) and Most Serious Problem: *Identity Theft, supra*.

<sup>38</sup> IRS response to TAS information request (July 13, 2011).

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

MSP #5

FY 1997, 85 percent of resolved ASFR assessments were “unagreed,” with the vast majority representing “no response” situations.<sup>39</sup> Current IRS data indicate that very little has changed in this regard — in fiscal year 2010, 83 percent of ASFR assessments were established as “unagreed.”<sup>40</sup>

**The IRS makes little effort to personally contact taxpayers before setting up ASFR assessments.**

The ASFR process does not require the IRS to try to reach taxpayers by phone to initiate personal contacts prior to assessments.<sup>41</sup> According to a 2005 TIGTA report, the IRS had planned to incorporate predictive dialer technology into the ASFR process in 2005 to facilitate outgoing calls.<sup>42</sup> TIGTA cited the positive results from a 1998 IRS test as evidence of the potential gains that increased telephone contacts could achieve.<sup>43</sup> This test was also referenced in the IRS’s own 1998 analysis of the ASFR program, which concluded, “the test demonstrated that the telephone contact in the ASFR program allowed the Service to help people understand their tax obligations and how to meet them, remedy the delinquency problem prior to enforcement action, and work with the taxpayers directly.”<sup>44</sup> This same study concluded, “There is considerable evidence that the ASFR program, when taxpayer contact is involved, provides meaningful service to “nonfiler” taxpayers.”<sup>45</sup> However, the IRS does not use predictive dialer technology in the ASFR program, nor has it increased emphasis on pre-assessment telephone contacts.<sup>46</sup>

**ASFR notices are confusing, misleading, and may discourage responses from taxpayers.**

The ASFR “90-day letter” (*i.e.*, the statutory notice of deficiency) notifies the taxpayer that a deficiency *has been* established, and instructs the taxpayer how to petition the Tax Court to contest the determination. Nowhere is the taxpayer advised that an original, self-reported tax return will stop the ASFR process. Instead, the notice advises the taxpayer that an assessment will be made in 90 days unless the taxpayer contests it by filing a petition with the Tax Court. This longstanding problem has been identified in past studies of the ASFR process.<sup>47</sup> The IRS’s Office of Taxpayer Correspondence (OTC), with participation by TAS,

<sup>39</sup> IRS, *Automated Substitute for Return (An Analysis from the Customer’s Perspective)* 12 (Nov. 1998).

<sup>40</sup> IRS response to TAS information request (July 13, 2011).

<sup>41</sup> IRM 5.18.1 (Apr. 20, 2010).

<sup>42</sup> Predictive dialer technology uses computer-directed outbound telephone dialing systems to dial a list of telephone numbers and connect answered dials to designated assistants of the business making the outgoing calls.

<sup>43</sup> TIGTA, Ref. No. 2005-30-073, *The Small Business/Self-Employed Division Has Made Significant Changes to Enhance the Automated Substitute for Return Program, but Opportunities Exist for Further Improvement* 8 (Apr. 2005). TIGTA cited a test conducted by the IRS in 1998 of the effectiveness of telephonically contacting taxpayers during the 30-day and 90-day letter process. The test data showed a 40 percent taxpayer response rate compared to 23 percent in FY 1997, the prior fiscal year during which outgoing telephone contacts were not part of the ASFR process, and a 33 percent return-secured rate compared to 13 percent in FY 1997.

<sup>44</sup> IRS, *Automated Substitute for Return (An Analysis from the Customer’s Perspective)* 9 (Nov. 1998).

<sup>45</sup> *Id.* at 11.

<sup>46</sup> IRS response to TAS information request (July 13, 2011).

<sup>47</sup> IRS, *Automated Substitute for Return (An Analysis from the Customer’s Perspective)* 8 (Nov. 1998).

has created a revised “90-day” letter that could improve taxpayer service in this critical area. However, the release of the new letter has been reprioritized and delayed a number of times, and is currently not scheduled until July 2012.<sup>48</sup>

**The IRS has a long history of taxpayer service problems in administering the ASFR reconsideration process.**

The ASFR process is designed to produce proposed assessments that exceed the likely self-reported liabilities of the affected taxpayers. This approach intends to encourage taxpayers to file original returns in order to take advantage of filing status elections, exemptions, deductions, and credits that will substantially reduce the proposed taxes due.<sup>49</sup> However, taxpayers who do not respond and file original returns until after the ASFR assessments have been made are subject to the ASFR reconsideration process.

Unfortunately, the IRS’s administration of the reconsideration process has been a problem area for many years. Prior studies have identified untimely resolution and inaccurate adjustments of ASFR cases as serious problems that “could adversely affect taxpayer relations” and are described by tax practitioners as “the most frustrating aspect of the entire program.”<sup>50</sup> In its 1998 analysis of ASFR, the IRS reported these reconsideration cases “have consistently been one of the most identified problems areas in PRP (the Problem Resolution Program) casework.”<sup>51</sup> This same report identified the complexity of adjusting ASFR reconsideration cases as a primary factor contributing to problems in this area.<sup>52</sup> In recent years, cases requiring reconsiderations of automated “enforcement assessments” have routinely been among the top problem issues in TAS cases.<sup>53</sup>

<sup>48</sup> IRS response to TAS information request (June 15, 2011).

<sup>49</sup> IRS, Letter 2566 (SC/CG) (Apr. 2005).

<sup>50</sup> TIGTA, Ref. No. 2005-30-073, *The Small Business/Self-Employed Division Has Made Significant Changes to Enhance the Automated Substitute for Return Program, but Opportunities Exist for Further Improvement* 18 (Apr. 2005). See also IRS, *Automated Substitute for Return (An Analysis from the Customer’s Perspective)* 10 (Nov. 1998).

<sup>51</sup> IRS, *Automated Substitute for Return (An Analysis from the Customer’s Perspective)* 10 (Nov. 1998). The Problem Resolution Program (PRP) was a taxpayer assistance and dispute resolution program and was the predecessor of the Taxpayer Advocate Service.

<sup>52</sup> *Id.* at 11. This report observed, “When ASFR audit reconsiderations are done, rather than completely reverse the ASFR assessments, including associated penalties and interest, and then post the original return amounts, the accounts are “adjusted.” Using the original return information, the ASFR assessments are changed to reflect the original return. Practitioners were unanimous that these “adjustments” often are not done correctly. We heard anecdotal accounts of situations where taxpayers continued to be billed for penalties and interest when original returns were filed showing refunds due. We believe the current process is overly, and needlessly, complicated. These service issues could be resolved with a more simplified process.”

<sup>53</sup> Taxpayer Advocate Management Information System (TAMIS) data show that TAS closed 9,202 cases involving automated enforcement assessments (TAS Issue Codes 620 and 760) during the first half of FY 2011, 19,679 in FY 2010, and 18,370 in FY 2009.

### The impact of automated “enforcement assessments” on the future voluntary compliance of affected taxpayers has yet to be determined.

In its 2005 audit, TIGTA raised a concern that the IRS does not track or report the subsequent voluntary compliance rates for individual taxpayers who are treated by the ASFR program.<sup>54</sup> The GAO expressed a similar concern in 2000.<sup>55</sup>

Despite these concerns, the IRS has not found a routine way to track the future filing compliance of taxpayers subject to ASFR assessments. In FY 2011, the IRS reported as CNC approximately four times the amount collected.<sup>56</sup> Of particular note, 69 percent of the dollars reported as CNC involved cases closed as “unable to locate or contact” and “surveyed” (*i.e.*, not pursued because the IRS determined the cases did not warrant the expenditure of additional collection resources).<sup>57</sup> With virtually no taxpayer contact required in these case dispositions, these results certainly raise significant questions about the impact of the current ASFR process on taxpayer compliance.

## CONCLUSION

While it appears that the IRS’s use of automated “enforcement assessments” may generate considerable potential accounts receivable, by design these assessments generally represent balances due that are inflated and inaccurate. Further, we find little evidence that this approach is effective in actually collecting delinquent revenue or promoting the future compliance by the affected taxpayers.

There is no dispute that the “nonfiler” population is a legitimate area of concern for the IRS. However, a truly effective “liability determination process” requires more emphasis on personal contact with the affected taxpayers. For many, the potential consequences of ASFR assessments can be severe. The IRS needs to place significantly more emphasis on delivering ASFR notices to correct addresses, and making subsequent communication efforts more service-oriented and designed to achieve “agreed” resolutions to the highest degree possible.

To address the concerns raised in this report, the National Taxpayer Advocate preliminarily recommends that the IRS:

1. Reinstate the policy of not making automated enforcement assessments without confirming that the taxpayer’s address of record is valid.

<sup>54</sup> TIGTA, Ref. No. 2005-30-073, *The Small Business/Self-Employed Division Has Made Significant Changes to Enhance the Automated Substitute for Return Program, but Opportunities Exist for Further Improvement* 1 (Apr. 2005); see also IRS, *Automated Substitute for Return (An Analysis from the Customer’s Perspective)* 8 (Nov. 1998).

<sup>55</sup> GAO, GAO/GGD-00-60R, *IRS’ Substitute for Returns* 2 (Feb. 2000). In this report the GAO observed, “IRS does not routinely collect data on the costs to prepare and process substitute for returns and the impacts of the SFR program on compliance. For example, IRS does not collect data on whether the taxpayer files for future tax years.”

<sup>56</sup> IRS, Collection Activity Report, NO-5000-242, *Type of Assessment Reports* (Oct. 2011).

<sup>57</sup> *Id.*

2. Require use of Form 4759, *Postal Tracer*, to confirm taxpayer addresses prior to making assessments in all “unagreed – no contact” situations.
3. Expedite the implementation of the revised ASFR “90-day” letter.
4. Revise ASFR processing procedures to emphasize telephonic contacts in all potentially “unagreed” ASFR assessments.
5. Revise ASFR selection criteria to reflect a minimum “likely balance due” of at least the amount of the current TDA issuance criteria. The ASFR selection process calculation can be based on last return filed information (*e.g.*, filing status, exemptions, and deductions). While the IRS may face legal restrictions in making elections for the taxpayer in establishing assessments, there are no such restrictions in considering this information in the criteria for selecting appropriate, productive cases for the ASFR treatment.
6. Revise procedures for processing audit reconsiderations on ASFR assessments. Rather than make “adjustments,” all ASFR assessed amounts, including penalties and interest, should be completely reversed and replaced with the amounts reflected on the taxpayer’s self-reported return.
7. Apply a pre-assessment “collectibility” determination to all potential ASFR assessments, including consideration of potential “unable to locate” and “little or no tax due” situations, and the potential for economic hardship based on the taxpayer’s income level. Consider the taxpayer’s last return filed information in making this determination.

## IRS COMMENTS

The Automated Substitute for Return program is one of the tools the IRS uses to bring taxpayers that fail to file a return into compliance. The program is an important part of tax administration and the IRS continually strives to improve the accuracy of Substitute for Return assessments. One of these changes to be implemented in the near future will allow better prioritization of cases. In April 2012, the IRS will implement programming that will select cases in a more optimal manner. The IRS is also implementing a new ASFR reconsideration tool in 2012 that will improve the reconsideration process. The tool will eliminate repetitive manual input by the IRS examiner and provide the examiner systemic reminders for needed tax information to ensure the examiner properly considers all related necessary adjustments. This tool will reduce the complexity of making these adjustments and ensure consistency among all examiners and all campuses.

The National Taxpayer Advocate’s report described ASFR’s “bulk processing” of assessments and their effect on collectability. The IRS agrees improvements can be made in the inventory selection methodology to improve collectability of the ASFR assessments and has made improvements to potentially increase collectability of ASFR assessments. To that end, an analysis was performed in 2009 and 2010 on the ASFR assigned inventory. Based on the review, processing changes were made in 2010 to prevent any delinquent module from entering the ASFR inventory if there is a balance due module for the same taxpayer.

Another change to be made in 2012 will block taxpayers who already have uncollectible modules from assignment to ASFR.

The National Taxpayer Advocate’s report also noted returns generated by the ASFR process increased 896 percent from 2002 to 2011. It is important to note that prior to 2002, the ASFR program was affected by budget cuts. Although the program continued to work responses from taxpayers, the number of Substitute for Return assessments decreased significantly. Beginning in 2002, as funding increased, ASFR began to increase SFR processing to ensure a balanced tax administration system.

The National Taxpayer Advocate’s report refers to studies conducted in 1991 and 1998 to support conclusions that ASFR should not generate enforcement assessments for cases when notices have been returned as undelivered or unclaimed. The report points out, based on these studies, the IRS instituted a policy to not establish ASFR assessments in cases without a confirmed address. The IRS utilized postal tracers to confirm addresses. The use of postal tracers was discontinued in March 2004 when the IRS determined the postal tracer checks were redundant to utilization of the National Change of Address Linkage (NCOA), which IRS was already using to confirm addresses since January 2001. Eliminating redundant steps conserves our resources while maintaining prudent and responsible program policies.

The National Taxpayer Advocate’s report makes seven preliminary recommendations to improve the ASFR program. The IRS is taking or has taken the following actions with respect to these recommendations.

With regard to confirming taxpayers’ addresses prior to automated enforcement assessments, the ASFR program performs due diligence in obtaining the most current address prior to each notice issuance. Significant changes have been made to ASFR processing to ensure the most current address is used. The IRS licenses the NCOA from the United States Postal Service (USPS). The consolidated data file with change-of-address information, based on updated address information received from postal customers, is received regularly from USPS.<sup>58</sup>

Although NCOA does not replace the postal tracer, it substantially reduces the need for it, and allows for additional resources to work ASFR taxpayer responses. Address changes received from NCOA and IRS contacts with taxpayers are systemically updated to ASFR prior to each notice issuance to ensure the most current address is being used. When notices are returned “undelivered” from the USPS, ASFR suspends activity on accounts and requests additional address research (using the Address Research System). Accounts are updated with new address information when the taxpayer confirms the address via letter 2797C or other contact, and notices are re-issued. ASFR continues enforcement activity only after all attempts to secure an updated address have failed. Unclaimed notices are

<sup>58</sup> IRM 5.1.18.12.

notices the USPS delivers to the taxpayer’s address of record, but are refused or unclaimed. ASFR does not consider those notices “undeliverable” because delivery is attempted to the correct address. Beginning in January 2012, balance due inventory that is currently not collectable due to “unable to locate” designations will not be reassigned to ASFR. The IRS will continue to perform due diligence in obtaining the most current addresses when ASFR letters are returned by the USPS. In addition, for field examinations, IRM 4.10.2.7.2.2, *Unlocatable Taxpayers—Mandatory Steps to Locate*, provides the steps to be followed by field examiners including research of internal sources, the asset locator service, the internet, the Currency Banking Retrieval System, and sending a postal tracer.

With respect to a revised ASFR 90-day letter, the IRS has already developed a revised letter, which will be ready for use by IRS systems in 2012.

The IRS agrees with the National Taxpayer Advocate that telephonic contact may assist taxpayers identified through the ASFR program; as such, we are currently pursuing the use of the predictive dialer. The predictive dialer program attempts to contact the taxpayer by telephone using the last known telephone number. Implementation will be dependent on resolution of systemic integration issues and contingent on available resources.

The IRS disagrees with the National Taxpayer Advocate’s draft recommendation to revise ASFR selection criteria to reflect a minimum “likely balance due” of at least the amount of the current Taxpayer Delinquent Account (TDA) issuance criteria. The ASFR program applies its current selection criteria to address non-compliance at its earliest stages. Early intervention and payment lessens the taxpayer’s exposure to additional interest and penalty and brings the taxpayer back into full compliance. Balance due assessments, which are lower than the current TDA issuance criteria, may still be paid by taxpayers in full or they may enter into installment agreements. In addition, ASFR does not factor in claimed entitlements from prior years when building inventory for the following reasons:

- The previously filed year may be two or more years prior to the unfiled year and may not be current information;
- A taxpayer’s employment, marital status, or dependents may have changed and may be the reason for not filing; and
- Subsequent actions for filed returns, such as underreporting of income, civil penalties, and examinations of dependents and EITC may not be present at the time the delinquent record is built.

The IRS disagrees it would be better for taxpayers to revise procedures for processing audit reconsiderations on ASFR assessments to completely reverse the ASFR assessment. We believe it is in the taxpayer’s best interest to adjust previously assessed amounts based on the received return. The Collection Statute Expiration Date (CSED) is ten years from the date of the Summary Record of Assessment (Form 23C). Each additional assessment of tax carries its own CSED of ten years. Abating the original ASFR assessment of tax, then

assessing the entire amount would set the CSED at ten years from the date of the new assessment.<sup>59</sup> It is for this reason returns (ASFR and amended) are not abated in full and re-assessed. ASFR Reconsiderations are worked similarly to amended returns. Line items are validated using information provided by taxpayers. The IRS will continue to strive to improve the accuracy of Substitute for Return assessments and reconsideration adjustments through training and systemic tools. As noted earlier, a new ASFR Reconsideration tool is currently under development and is due to be implemented by 2012.

As previously discussed, the IRS is already taking steps to improve the ASFR case selection criteria. The IRS will implement programming in April 2012 that will change the prioritization of started ASFR cases. The IRS is also considering a proposal to implement “scoring” for ASFR inventory that will enable taxpayers to be examined for collectability prior to entering the ASFR treatment stream. ASFR inventory is selected based on dollar criteria that limits “little or no tax due” situations; but lower dollar inventory has been received in ASFR as reassignments from other collection areas. In February 2011, a change was made to IRM 5.19.2.6.4.3 instructing other collection areas within IRS to not refer modules to ASFR unless they meet established dollar criteria.

### Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS is striving to improve the accuracy of ASFR assessments, and welcomes the assurances that changes are planned for fiscal year 2012 to improve the prioritization of cases selected for the ASFR program. We are also pleased that the IRS plans to implement a new ASFR reconsideration tool in FY 2012 that has been designed to reduce the complexity involved in making adjustments in the ASFR reconsideration process. The new tool will eliminate repetitive manual input by IRS examiners, and provide systemic reminders to ensure that all necessary adjustments are properly considered. This initiative appears to have good potential to improve the service and quality of work performed at the “back-end” of the ASFR process. Further, the progress on the development of a revised ASFR “90-day” letter is encouraging. The implementation of this process improvement is long overdue, and we look forward to seeing the new letter put into service in FY 2012, as planned.

The IRS response contends that the astounding 896 percent increase in ASFR assessments from 2002 to 2011 was a product of increased funding for the program “to ensure a balanced tax administration system.” Nevertheless, IRS data reveal that 2.7 million ASFR

<sup>59</sup> IRM 25.6.1.12(2) and (4).

initial notices were issued in FY 2003, with only 128,319 ASFR assessments made that year.<sup>60</sup> By FY 2005, although the number of ASFR initial notices had actually *decreased* by five percent, the number of ASFR assessments was 484 percent of the number of assessments made in FY 2003.<sup>61</sup> The most significant change to the ASFR program during this timeframe, which occurred in March 2004, was the discontinued use of postal tracers to confirm the validity of taxpayer addresses used in ASFR assessments.

The IRS response indicates that ASFR assessments are completed “only after all attempts to secure an updated address have failed.” While this statement may be accurate, the National Taxpayer Advocate remains concerned that the attempts by the IRS to confirm taxpayer addresses prior to establishing these enforcement assessments are inadequate. The IRS claims that although the use of the National Change of Address database does not replace the postal tracer, “it substantially reduces the need for it.” While the NCOA database may be a useful tool for identifying new addresses for some taxpayers, the manner in which the IRS Collection operation uses NCOA as the primary vehicle to confirm taxpayer addresses is a questionable practice. Significant concerns in the areas of address verification and the processing of taxpayer mail responses have recently been raised by the National Taxpayer Advocate and TIGTA.<sup>62</sup>

As discussed in this report, IRS program data reveal that routinely over 80 percent of ASFR assessments have been established as “unagreed,” primarily due to no response from the taxpayers. Consequently, IRS data also indicate that less than ten percent of ASFR assessments are actually collected, while substantial portions of these assessments are reported as uncollectible or assigned to the Collection Queue inventory. Contrary to the IRS’s response, these results do not reflect program decisions that have conserved resources “while maintaining prudent and responsible program policies.” While the IRS indicates in its response that “balance due assessments, which are lower than the current TDA issuance criteria, *may* (emphasis added) still be paid by taxpayers in full or they may enter into installment agreements,” it provides no factual data to support this assumption.

It is noteworthy that the IRS response refers to the procedures used by the Examination function to locate taxpayers involved with Exam field audits, including field-generated substitute for return cases.<sup>63</sup> These procedures reflect a much more sincere and effective attempt to secure an updated address for the taxpayer, including the use of the Form 4759, *Postal Tracer*. Unfortunately, these practices are not reflected in the Collection ASFR

<sup>60</sup> IRS, Collection Activity Report, NO-5000-139, *National Delinquent Return Activity Report (2003–2005)*. IRS Data Book (2003–2005), Information Reporting Program, Table 25, at [www.irs.gov/taxstats/index.html](http://www.irs.gov/taxstats/index.html).

<sup>61</sup> *Id.* In FY 2005, 2,578,000 ASFR initial notices were issued and 620,632 ASFR assessments were generated.

<sup>62</sup> National Taxpayer Advocate 2010 Annual Report to Congress 221-234 (Most Serious Problem: *The IRS Has Not Studied or Addressed the Impact of the Large Volume of Undelivered Mail on Taxpayers*); National Taxpayer Advocate 2010 Annual Report to Congress 235-249 (Most Serious Problem: *The IRS Does Not Process Vital Taxpayer Responses Timely*); TIGTA, Ref. No. 2010-40-055, *Current Practices Are Preventing a Reduction in the Volume of Undeliverable Mail* (May 14, 2010); TIGTA, Ref. No. 2011-30-051, *Challenges Remain When Processing Undeliverable Mail and Preventing Violations of Taxpayers’ Rights During the Lien Due Process* (May 13, 2011).

<sup>63</sup> IRM 4.10.2.7.2.2, *Unlocatable Taxpayers—Mandatory Steps to Locate* (May 2, 2010).

program. The National Taxpayer Advocate is concerned that this situation is an example of how removal of the “human element,” which is too often indicative of IRS automated enforcement programs, results in reductions in quality casework and taxpayer service. From the taxpayers’ perspective, the ASFR process is no less an audit than those conducted by Examination.<sup>64</sup> Therefore, any less concern for protecting taxpayer rights is inappropriate. The absence of IRS-initiated contacts in the ASFR process exacerbates these concerns. Questions regarding the taxpayer’s marital status and dependents can be easily addressed with a personal contact at the front end of the process, eliminating significant burden from the affected taxpayer and the need for “back-end” adjustments by the IRS. The IRS claims to be considering the use of predictive dialer technology to facilitate more contacts. However, we have noted in this report that the IRS made a similar claim to TIGTA in response to a 2005 audit. Yet, the value of personal contacts during the auditing process continues to be undervalued and underutilized in the ASFR program.

The National Taxpayer Advocate acknowledges the legal barriers to adjusting ASFR assessments in the manner suggested, and we are modifying our preliminary recommendation. However, the fact remains that problems with ASFR reconsiderations consistently surface in TAS cases, and this “back-end” portion of the ASFR process requires improvement. We acknowledge the IRS commitment to improve the accuracy of ASFR reconsiderations through training and implementation of the new ASFR reconsideration tool, and look forward to confirming improvements in this area in FY 2012. Further, the matter of timeliness in addressing and resolving ASFR reconsiderations remains a concern. The IRS needs to ensure that adequate resources are allocated to the ASFR reconsideration process to ensure timely resolutions of these cases.

While the National Taxpayer Advocate is pleased the IRS has acknowledged the need to improve the case selection methodology used in the ASFR program, we have concerns with the response indicating that this work will be accomplished primarily through “programming” changes. These systemic changes, such as excluding from the ASFR process return delinquencies associated with other balance due modules — including those reported as uncollectible — do not address the root problems of the ASFR process; however, these changes could actually prove to be detrimental to the IRS’s overall non-filer strategy. We urge the IRS to recognize that although automation can certainly be a useful tool in the administration of the non-filer program, an effective program must be more concerned with collection of the proper amount of tax due from the delinquent taxpayers, with an ultimate goal of assisting these taxpayers to become and remain fully compliant. As discussed in this report, the current ASFR program does not appear to be successful in attaining either of these goals.

<sup>64</sup> See also *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*, *supra*.

## Recommendations

The National Taxpayer Advocate offers the following recommendations:

1. Reinstate the policy of not making automated enforcement assessments without confirming that the taxpayer’s address of record is valid, and require use of Form 4759, *Postal Tracer*, to confirm taxpayer addresses prior to making assessments in all “unagreed – no contact” situations.
2. Follow through on current plans to implement the revised ASFR “90-day” letter in FY 2012.<sup>65</sup>
3. Revise ASFR processing procedures to emphasize the completion of telephonic, personal contacts with the affected taxpayers in all potentially “unagreed” ASFR cases prior to assessment.
4. Allocate adequate resources to the ASFR reconsideration process to ensure adjustments are initiated and completed in a timely manner.
5. Apply a pre-assessment collectibility determination to all potential ASFR assessments, including consideration of potential “unable to locate” and “little or no tax due” situations, and the potential for economic hardship based on the taxpayer’s income level. Consider the taxpayer’s last return filed information in making this determination.

<sup>65</sup> Generally, the National Taxpayer Advocate does not propose a formal recommendation in situations where the IRS has indicated in its response that the recommended action will be implemented. However, the IRS has been in agreement with the need for a revised ASFR “90-day” letter for several years; yet, the new letter has not yet been implemented. This recommendation urges the IRS to deliver on plans to implement the revised letter in FY 2012, without further delay.

MSP  
#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****RESPONSIBLE OFFICIALS**

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

**DEFINITION OF PROBLEM**

A recent IRS focus group report ranked the filing of the Notice of Federal Tax Lien (NFTL) as the number one factor that affects a taxpayer's economic circumstances and credit report, ranking even higher than foreclosure and bankruptcy.<sup>1</sup> 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 have a negative effect on the compliance behavior and financial viability of affected taxpayers.<sup>2</sup> The study shows that taxpayers 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, and still over 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.<sup>3</sup> 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, and 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.<sup>4</sup> Some IRS lien filings may make no business sense at all — generating significant downstream costs for the government without attaching to any tangible assets.<sup>5</sup>

The National Taxpayer Advocate has repeatedly expressed concerns about the adverse impact of IRS lien filing policies on taxpayers and future compliance.<sup>6</sup> She has proposed several administrative and legislative steps to improve these policies and procedures, and

<sup>1</sup> Final Report: *Federal Tax Liens, the General Public, and Credit Report Considerations* iv, 2010 Nationwide Tax Forum Focus Groups, Small Business/Self-Employed Division (SB/SE) Research, Denver, Project DEN0141 (Dec. 2010).

<sup>2</sup> See TAS Research Study: *Estimating the Impact of Liens on Taxpayer Compliance Behavior and Income*, Vol. 2, *infra*.

<sup>3</sup> *Id.*

<sup>4</sup> Total Positive Income is calculated by summing the positive values from the following income fields from a taxpayer's most recently filed individual tax return: wages; interest; dividends; distribution from partnerships, small business corporations, estates, or trusts; Schedule C net profits; Schedule F net profits; and other income such as Schedule D profits and capital gains distributions. Losses reported for any of these values are treated as zero.

<sup>5</sup> See T. Keith Fogg, *Systemic Problems With Low-Dollar Lien Filing*, 2011 TNT 194-9 (Oct. 6, 2011). (The author, a former attorney with the IRS Office of Chief Counsel and currently an Associate Professor of Law and Director of the Federal Tax Clinic at the Villanova University School of Law, provides a thorough and detailed discussion of downstream costs of an NFTL filing and the "long period of the NFTL maintenance" for the government.)

<sup>6</sup> National Taxpayer Advocate Fiscal Year 2012 Objectives Report to Congress 12-13; National Taxpayer Advocate 2010 Annual Report to Congress 302-310; National Taxpayer Advocate 2009 Annual Report to Congress 17-40; National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 1-18. See also National Taxpayer Advocate 2009 Annual Report to Congress 357-364.

to grant relief to taxpayers harmed by automatic filings.<sup>7</sup> 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 NFTLs.<sup>8</sup>

Despite these changes, the IRS filed 1,042,230 NFTLs in fiscal year (FY) 2011 against 713,524 taxpayers.<sup>9</sup> 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.<sup>10</sup> 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.

With the preliminary results of the new TAS study in hand, the National Taxpayer Advocate has offered to work with the IRS on new, meaningful lien filing criteria. These standards would be based on the effectiveness of filings in increasing revenue, promoting future compliance, and minimizing economic harm.<sup>11</sup> The IRS’s commitment to this collaborative effort has the potential to create a solid foundation for improved future compliance, increased revenue, and long-awaited relief for financially struggling taxpayers.

## ANALYSIS OF PROBLEM

### Background

The IRS filed nearly 1.1 million NFTLs in FY 2010, an increase of about 550 percent from FY 1999, despite scant evidence that liens generate commensurate tax revenue.<sup>12</sup> The IRS continues to file most NFTLs based on a threshold amount of liability, without considering the existence of assets, the likelihood that the taxpayer will acquire assets during the remaining statute of limitations, and the taxpayer’s history of compliance. The National Taxpayer Advocate has opposed this practice for years, and has proposed and advocated for

<sup>7</sup> See Taxpayer Advocate Directive (TAD) 2010-1, *Immediately discontinue automatic lien filing on Currently Not Collectible (CNC) hardship accounts with an unpaid balance of \$5,000 or more, require employees to make meaningful notice of federal tax lien (NFTL) filing determinations, and require managerial approval for filings of an NFTL in all cases where the taxpayer has no assets* (Jan. 20, 2010); TAD 2010-2, *Withdrawal of a notice of federal tax lien (NFTL) where the statutory withdrawal criteria are satisfied, even if the underlying lien has been released* (Jan. 20, 2010). For copies of the TADs, see National Taxpayer Advocate Fiscal Year 2011 Objectives Report to Congress, Appendix VIII, available at <http://www.irs.gov/pub/irs-utl/nta2011objectivesfinal..pdf>.

<sup>8</sup> IRS, Media Relations Office, *IRS Announces New Effort to Help Struggling Taxpayers Get a Fresh Start; Major Changes to Lien Process*, IR-2011-20. (Feb. 24, 2011).

<sup>9</sup> IRS, Collection Activity Report NO-5000-23, *Collection Workload Indicators* (Oct. 11, 2011); IRS, Compliance Data Warehouse (CDW), Individual Master File Transaction (IMF) History Table and Business Master File (BMF) Transaction History Table, Fiscal Year (FY) 2011 (Extracted by TAS Research and Analysis).

<sup>10</sup> IRS, Collection Activity Report NO-5000-23, *Collection Workload Indicators* (Oct. 30, 2011); IRS, *Fiscal Year 2010 Enforcement Results*, available at [http://www.irs.gov/pub/irs-utl/2010\\_enforcement\\_results.pdf](http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf).

<sup>11</sup> See TAS Research Study: *Estimating the Impact of Liens on Taxpayer Compliance Behavior and Income*, Vol. 2, *infra*. See also National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 89-100 (TAS Research and Related Studies: *Estimating the Impact of Liens on Taxpayer Compliance Behavior: An Ongoing Research Initiative*).

<sup>12</sup> IRS, *Fiscal Year 2010 Enforcement Results*, available at [http://www.irs.gov/pub/irs-utl/2010\\_enforcement\\_results.pdf](http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf). During FY 1999-2009, when adjusted for inflation, the total dollars collected actually declined by about seven percent from \$29.4 billion to \$27.2 billion (in terms of real dollars valued as of 2009). IRS, *Statistics of Income (SOI) Data Books, Table 16, Delinquent Collection Activities, 1999-2009*. See also Bureau of Labor Statistics, Dept. of Labor, *Consumer Price Index - All Urban Consumers (CPI-U)*, available at <http://www.bls.gov/CPI/>.

alternatives to current lien filing practices.<sup>13</sup> The IRS filed 1,042,230 NFTLs in FY 2011, a decrease of about five percent from FY 2010, most likely due to the “fresh start” initiative.<sup>14</sup> In terms of the number of taxpayers affected by NFTLs, 713,524 taxpayers had liens filed against them in FY 2011 compared to 776,054 in FY 2010, a decrease of 62,530 or about eight percent.<sup>15</sup>

TAS’s comprehensive analysis of IRS lien filing practices has shown that during the past few years:

- *NFTLs do not increase collection revenue.* The IRS raised lien filings by about 550 percent from FY 1999 to FY 2010 despite scant evidence that liens generate commensurate tax revenue.<sup>16</sup>
- *The IRS does not know how much money NFTLs bring in.* While less than half of the delinquent tax payments analyzed definitively identified the payment sources, payments associated with liens amount to less than \$1 out of every \$5 of payments.<sup>17</sup>
- *NFTL filing practices do not consider the existence of assets or equity in assets and harm taxpayers experiencing economic hardship.* NFTLs were responsible for only \$2 of every \$10 in payments collected from taxpayers in currently not collectible (CNC) status, while nearly \$6 of every \$10 collected from these taxpayers resulted from refund offsets.<sup>18</sup> Nonetheless, the IRS filed NFTLs against more than 72 percent of these taxpayers in tax year (TY) 2009.<sup>19</sup>

<sup>13</sup> National Taxpayer Advocate Fiscal Year 2012 Objectives Report to Congress 12-13; National Taxpayer Advocate 2010 Annual Report to Congress 302-310; National Taxpayer Advocate 2009 Annual Report to Congress 17-40; National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 1-18. See also National Taxpayer Advocate 2009 Annual Report to Congress 357-364; TADs 2010-1 and 2010-2.

<sup>14</sup> IRS, Collection Activity Report NO-5000-23, *Collection Workload Indicators* (Oct. 11, 2011).

<sup>15</sup> IRS, CDW, IMF and BMF Transaction History Tables, FY 2011 (Extracted by TAS Research & Analysis). Some taxpayers may have multiple NFTLs filed against them for separate accounts or liabilities incurred in subsequent tax periods.

<sup>16</sup> During FY 1999-2009, when adjusted for inflation, the total dollars IRS collected actually declined by about seven percent from \$29.4 billion to \$27.2 billion (in terms of real dollars valued as of 2009). National Taxpayer Advocate 2010 Annual Report to Congress 302-310.

<sup>17</sup> See National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 1-18 (TAS Study: *The IRS’s Use of Notices of Federal Tax Lien*). The IRS assigns a Designated Payment Code (DPC) to each subsequent, post-assessment payment it receives to identify the source. In 2009, TAS analyzed 1,886,683 total payment transactions, of which only 629,158 transactions had the DPC code assigned. 1,257,525 transactions were designated “miscellaneous” or “DPC indicator not present.” Of the 1,257,525 transactions, 283,091 had a refund offset transaction code; leaving 974,434 payments (or 51.6 percent) as unaccountable. Thus, 912,249 payments (or 48.4 percent) had meaningful DPCs or could be identified as refund offsets. See also National Taxpayer Advocate 2010 Annual Report to Congress 250-266 (Most Serious Problem: *The IRS Should Accurately Track Sources of Balance Due Payments to Determine the Revenue Effectiveness of Its Enforcement Activities and Service Initiatives*).

<sup>18</sup> TAS pulled the subset of 35,919 CNC hardship taxpayers with refund offset or specific DPC coding from the 270,399 individual taxpayers who first incurred new balance due delinquencies in TY 2002, had no previous unpaid tax liabilities at that time, and against whom NFTLs were filed in subsequent years. It does not include those payments that were coded as “Miscellaneous” or had no DPC coding. IRS, Compliance Data Warehouse (CDW), Individual Masterfile (IMF) Transaction File Cycle 200913. See also National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 1-18 (*The IRS’s Use of Notices of Federal Tax Lien*).

<sup>19</sup> National Taxpayer Advocate 2009 Annual Report to Congress 17-40.

**Focus Group Reports Confirm That an NFTL May Devastate a Taxpayer's Financial Situation, Impair the Taxpayer's Ability to Pay Off Liabilities, and Hinder Collection and Future Compliance.**

A recent IRS focus group report ranked the filing of the NFTL as the leading factor that affects a taxpayer's economic circumstances and credit report, with a greater effect than even foreclosure or bankruptcy.<sup>20</sup> Tax practitioners who took part in focus groups (at the IRS Nationwide Tax Forums) stated the liens hurt their clients and make it harder to obtain credit, including funds to pay off the very liabilities the NFTLs were supposed to secure.<sup>21</sup> The focus group respondents indicated the NFTL filing would negatively affect credit reports, job applications, loan applications, insurance rates, refinancing, sales of property, rent or leasing opportunities, and interest rates.<sup>22</sup>

Focus group participants stated NFTLs affect different types of taxpayers: seniors, people in poverty, wage earners, unemployed taxpayers, and business taxpayers such as sole proprietorships, small corporations, and self-employed taxpayers.<sup>23</sup> Participants in a recent TAS focus group also indicated that hasty filing of NFTLs could be especially devastating for small businesses that cannot obtain financing or bonding to continue in business.<sup>24</sup> Some businesses fail because they cannot meet their financial obligations when a lien filed early in the collection process derails future contracts.<sup>25</sup>

Comments from those responding to the IRS survey include:

- The IRS is “pulling the switch on federal tax liens too early; small businesses don't get an opportunity to restructure their loans to pull money out to pay the liability.”
- The lien should be “the last thing the IRS uses. The revenue officer should have the ability to assess the taxpayer's situation and hold off on filing the lien.”
- The lien is “not doing what the IRS believes it is doing.”
- “Liens work against the government getting paid.”
- “The government assumes the taxpayer has money and the lien is needed to get that money. In reality the taxpayer doesn't have the money.”
- “The lien lowers the credit score 100 points but it won't go back up if the taxpayer pays the liability.”

<sup>20</sup> Final Report: *Federal Tax Liens, the General Public, and Credit Report Considerations* iv, 2010 Nationwide Tax Forum Focus Groups, SB/SE Research, Denver, Project DENO141 (Dec. 2010).

<sup>21</sup> SB/SE Report at 10. One participant stated that even if the taxpayer was in a financial position to borrow money, it could not obtain financing after the NFTL is filed.

<sup>22</sup> *Id.* Some respondents indicated that many taxpayers whose credit is compromised adopt their children's Social Security numbers to obtain credit or open bank accounts, which may affect the children's ability to receive student loans or credit in the future. One participant mentioned a taxpayer who used a deceased parent's credit card because the account was in good standing and he could not obtain his own credit because of an NFTL.

<sup>23</sup> *Id.* at 11.

<sup>24</sup> TAS Focus Group Report: *Collection Issues for Small Businesses* 30, 2011 Nationwide Tax Forums (Oct. 2011).

<sup>25</sup> SB/SE Report at 10.

The suggestions offered by respondents from both focus groups to minimize the impact of the lien on taxpayers include:

- Allow appeal of the NFTL filing before the lien is filed. The process should be consistent with the appeal process for levies, which allows for reconsideration prior to the IRS issuing the levy.
- Permit face-to-face conferences between the taxpayer and collection personnel and allow cases to be transferred locally.
- Give the taxpayer more time to resolve the liability before filing an NFTL.
- Settle a case quickly so the taxpayer does not accrue unnecessary penalties and interest.
- File liens only as a last resort (after installment agreements default).<sup>26</sup>

Most participants stated a lien has a negative effect on a taxpayer's future compliance.<sup>27</sup> Practitioners say some taxpayers will not file returns or will stop filing them, while more frustrated taxpayers will be forced into an underground economy where they will deal in cash only.

#### **Preliminary Results From a TAS Research Study Indicate That NFTL Filings May Negatively Affect Future Tax Compliance.**

At the request of the National Taxpayer Advocate, TAS Research & Analysis is conducting a multi-year, comprehensive study of the impact of NFTLs on delinquent taxpayers' current and future payment and filing compliance and their ability to earn income.<sup>28</sup> The results of this analysis will help the National Taxpayer Advocate and the IRS better understand the effectiveness of NFTLs.

TAS Research and Analysis analyzed data from all taxpayers who had no liabilities in the beginning of processing year (PY) 2002 and incurred liabilities during processing year (PY) 2002 (a total of 127,406 delinquent taxpayers).<sup>29</sup> Working with this population of taxpayers, TAS used a propensity score matching process to establish comparable groups of lien (*i.e.*, taxpayers against whom the IRS filed liens) and nonlien (*i.e.*, taxpayers against whom IRS *should* have had liens filed against, *but did not*) taxpayers that could be used to

<sup>26</sup> See Final Report: *Federal Tax Liens, the General Public, and Credit Report Considerations* iv, 2010 Nationwide Tax Forum Focus Groups, SB/SE Research, Denver, Project DENO141 (Dec. 2010); TAS Focus Group Report: *Collection Issues for Small Businesses* 31, 2011 Nationwide Tax Forums (Oct. 2011).

<sup>27</sup> Final Report at 15.

<sup>28</sup> See TAS Research Study: *Estimating the Impact of Liens on Taxpayer Compliance Behavior and Income*, Vol. 2, *infra*. See also National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 89-100 (TAS Research and Related Studies: *Estimating the Impact of Liens on Taxpayer Compliance Behavior: An Ongoing Research Initiative*).

<sup>29</sup> The processing year is the calendar year in which the return was processed by the IRS. We chose tax year 2002 to allow a sufficient time interval to elapse to analyze subsequent payments.

study the impact of lien filing.<sup>30</sup> The resulting groups had 63,703 lien taxpayers and 63,703 nonlien taxpayers.<sup>31</sup>

TAS then analyzed 1,146,654 transactions for both groups in processing years 2002-2010 to evaluate the marginal effect of a lien filing on the following conditions:<sup>32</sup>

- *Current payment activities, i.e.*, increasing or decreasing the likelihood that delinquent taxpayers in both groups make sufficient payments to reduce their original liability incurred in PY 2002;
- *Future payment activities, i.e.*, increasing or decreasing the likelihood that delinquent taxpayers in both groups make sufficient payments to reduce their total tax liability, excluding the original tax liability incurred in PY 2002;
- *Future filing activities, i.e.*, increasing or decreasing the likelihood that delinquent taxpayers in both groups will file the required tax returns in calendar years (CYs) 2003-2010; and
- *The ability to generate future income, i.e.*, increasing or decreasing the likelihood that the total positive income of delinquent taxpayers in both groups in the next periods is greater than the 2002 total positive income.<sup>33</sup>

Preliminary results show that the lien filing was a significant factor that created negative marginal effects for all conditions and for all analyzed periods.<sup>34</sup> The lien taxpayers were about six percent less likely to make sufficient payments to reduce their original liability incurred in PY 2002 during CYs 2002-2005, with negative outcomes gradually decreasing over the years to about four and half percent for CYs 2002-2010. We found that through 2008, at least four years after the lien was filed, taxpayers with liens were still over five percent less likely to reduce their initial liabilities than comparable non-lien taxpayers. 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, *i.e.*, through CY 2010. Finally, lien taxpayers were less likely to have an increase in

<sup>30</sup> See Rosebaum and Rubin (*The Central Role of Propensity Score in Observational Studies for Causal Effects, Biometrika*, 1983, Vol 70, 1, 41-55) developed this method. The propensity score method addresses the selection bias by pairing, in our case, lien taxpayers, and non-lien taxpayers, where they are similar in observable characteristics that influence the IRS's lien filing determination. For a detailed design of the study, see TAS Research Study: *Estimating the Impact of Liens on Taxpayer Compliance Behavior and Income*, Vol. 2, *infra*.

<sup>31</sup> These groups share the same characteristics based on then-existing lien filing requirements. IRM 5.12.1.13(2) (July 31, 2001); IRM 5.12.2.8.1(4) and (5) (Mar. 1, 2004); IRM 5.19.4.5.2(2)-(7) (Aug. 30, 2001).

<sup>32</sup> The first three activities address the general conditions underlying tax compliance behavior. If taxpayers are filing timely and paying timely on current and future liabilities, we would conclude that these taxpayers are compliant. The last condition focuses on the potential harm that can emerge from an NFLT for delinquent taxpayers, including a negative effect on credit scores. The marginal effect reports the estimated percentage change in the probability of the event (payment, filing, or having more income), given the treatment (tax lien filing) has occurred.

<sup>33</sup> Total positive income is calculated by summing the positive values from the following income fields from a taxpayer's most recently filed individual tax return: wages; interest; dividends; distribution from partnerships, small business corporations, estates, or trusts; Schedule C net profits; Schedule F net profits; and other income such as Schedule D profits and capital gains distributions. Losses reported for any of these values are treated as zero.

<sup>34</sup> The lien effect was examined over six defined timeframes, PYs 2002-2005, PYs 2002-2006, PYs 2002-2007, PYs 2002-2008, PYs 2002-2009, and PYs 2002-2010. These periods captured the characteristics of the subjects (delinquent taxpayers) at the endpoint years of the timeframe. The negative effects of an NFLT decrease over time, with the highest negative impact to be within first three to five years after the NFLT filing.

their total positive income, 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. By CY 2010, the overall effect of the lien was that these taxpayers would have, on average, a 6.6 percent likelihood of lower total positive income.

Lien filing had positive affects on future payment activities. For example, the study shows that the lien taxpayers were about 5.6 percent more compliant on their future payment obligations than the non-lien taxpayers in the first three years after the lien filing, gradually declining to about one percent within seven years after the lien filing. It appears that the lien filing may have made the affected taxpayers more careful in the immediate years, but that care eroded over time. We should note that for future income, the cumulative effect of such a reduction may have interplay with the generally negative trend for future payment compliance.

In summary, delinquent taxpayers in the study with liens filed against them were less likely than comparable taxpayers without liens to pay current liabilities, timely file required returns in the future, and generate greater positive income in future tax periods.

The TAS study demonstrates that liens filed under current criteria can be detrimental to compliance and the financial viability of affected taxpayers. TAS Research & Analysis plans to investigate criteria that could change the lien filing outcomes to have a positive impact on filing and payment compliance without needlessly harming taxpayers. We also may explore whether the future payment compliance improved because of payments not attributable to the lien (*e.g.*, refund offsets, levies, or installment agreements). TAS invites the IRS to take part in this research project and use its findings for redesigning lien filing criteria.

#### **The IRS's Fresh Start Initiative is a Step in the Right Direction.**

The IRS is to be commended for trying to take “common sense” approaches to collection policy. TAS worked very closely with the Collection function in developing and clearing procedural guidance related to the “Fresh Start” initiative,<sup>35</sup> which included:

- Doubling the dollar threshold for filing most NFTLs from \$5,000 to \$10,000, resulting in fewer NFTLs;<sup>36</sup>
- Changing procedures for NFTL withdrawals after lien releases;<sup>37</sup>
- Withdrawing liens in most cases where a taxpayer enters into a DDIA;<sup>38</sup> and

<sup>35</sup> IRS Announcement IR-2011-20, IRS Announces New Effort to Help Struggling Taxpayers Get a Fresh Start; Major Changes Made to Lien Process, at <http://www.irs.gov/newsroom/article/0,,id=236540,00.html> (last visited July 11, 2011).

<sup>36</sup> SB/SE, *Interim Guidance Memorandum*, Control No. SBSE-05-0311-039 (Mar. 28, 2011).

<sup>37</sup> SB/SE, *Interim Guidance Memorandum*, Control No. SB/SE-05-0611-037 (June 10, 2011). This guidance was issued in response to TADs 2010-1 and 2010-2. See also National Taxpayer Advocate FY 2012 Objectives Report to Congress 12.

<sup>38</sup> SB/SE, *Interim Guidance Memorandum*, Control No. SBSE-05-0411-036 (Apr. 7, 2011).

- Setting the minimum lien filing threshold on subsequent tax modules at \$2,500 or more.<sup>39</sup>

These changes, however, do not rescind the IRS policy of automatically filing liens based on a dollar threshold of the unpaid tax liability, instead of basing a lien-filing determination on a thorough analysis of the taxpayer's circumstances. Although the short-term impact of changes from the Fresh Start appears promising, the decrease in NFTL filings so far has been minimal, given the millions of liens filed in recent years.<sup>40</sup>

**Without Meaningful Criteria the IRS Cannot Improve its Lien-Filing Decision Process, Which Harms Taxpayers, Collection Revenue, and Future Compliance, Especially for Low Income and No-Assets Cases.**

TAS research studies and focus group reports have sufficiently demonstrated that current lien filing policies and practices actively and unnecessarily harm taxpayers and tax compliance, without increasing revenue.<sup>41</sup> Particularly for low income and currently not collectible accounts, the IRS has no sound policy or revenue basis for filing liens based on a dollar threshold of liability, without prior personal contact with the taxpayer and verification of assets and equity.

*Lien filings should make business sense.*

The IRS incurs significant downstream costs for each filing but cannot measure its effectiveness in terms of collected revenue.<sup>42</sup> These downstream costs begin with the upfront costs: an NFTL mailing fee, the certified mail fee for the Collection Due Process (CDP) notice, and the NFTL recording fee.<sup>43</sup> However, administrative costs may be significant and involve substantial time for higher-graded employees at the Office of Appeals, the

<sup>39</sup> SB/SE, *Interim Guidance Memorandum*, Control No. SBSE-05-0511-050 (May 13, 2011).

<sup>40</sup> The IRS filed 5,200,913 NFTLs during FYs 2004-2010. IRS, *Fiscal Year 2010 Enforcement Results*, available at [http://www.irs.gov/pub/irs-utl/2010\\_enforcement\\_results.pdf](http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf). The number of NFTL filings in FY 2011 decreased by only 54,000 or about five percent compared to FY 2010 as described above. This figure is consistent with Collection Process Study estimates that a change in threshold would reduce the IRS's 1.1 million annual lien filings by only 40,000 to 41,000, or about four percent. IRS, *Collection Process Study (CPS) 122* (Sept. 30, 2010).

<sup>41</sup> See TAS Research Study: *Estimating the Impact of Liens on Taxpayer Compliance Behavior and Income*, Vol. 2, *infra*. National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 89-100 (TAS Research and Related Studies: *Estimating the Impact of Liens on Taxpayer Compliance Behavior: An Ongoing Research Initiative*); National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 1-18 (TAS Research Study: *The IRS's Use of Notices of Federal Tax Lien*). See also Final Report: *Federal Tax Liens, the General Public, and Credit Report Considerations* iv, 2010 Nationwide Tax Forum Focus Groups, SB/SE Research, Denver, Project DEN0141 (Dec. 2010); TAS Focus Group Report: *Collection Issues for Small Businesses* 31, 2011 Nationwide Tax Forums (Oct. 2011).

<sup>42</sup> The IRS cannot track the source of payments on past due accounts to measure the effectiveness of its collection actions. See National Taxpayer Advocate 2010 Annual Report to Congress 250-266 (Most Serious Problem: *The IRS Should Accurately Track Sources of Balance Due Payments to Determine the Revenue Effectiveness of Its Enforcement Activities and Service Initiatives*).

<sup>43</sup> See T. Keith Fogg, *Systemic Problems with Low-Dollar Lien Filing*, 2011 TNT 194-9 (Oct. 6, 2011) for a thorough and detailed discussion of downstream costs of an NFTL filing and the "long period of the NFTL maintenance" for the government). For example, the IRS estimates that a lien filing costs between \$25 and \$100, plus labor costs. IRS, *Collection Process Study (CPS) 122* (Sept. 30, 2010). The IRS may spend up to \$109 million in lien filing costs annually, not including labor costs, based on 1,096,376 NFTLs filed in FY 2010. IRS, *Fiscal Year 2010 Enforcement Results*, available at [http://www.irs.gov/pub/irs-utl/2010\\_enforcement\\_results.pdf](http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf). There are no estimates for the downstream costs of time spent by the IRS Offices of Appeals, CFF, Taxpayer Advocate Service, and Chief Counsel in resolving an NFTL case, including a CDP hearing and supporting the case through the court system. TAS direct costs for resolving lien issues exceeded \$2.3 million and 31,600 hours in FY 2011. FY 2011 lien case counts include issue codes 720, 721, 722, 723, 724, and 729. The FY11 average salary includes benefits for case advocates, intake advocates, lead case advocates, and technical advisors.

Collection Field function (Cff), the Taxpayer Advocate Service, and the Office of Chief Counsel, when the filing is contested at a CDP hearing or in the U.S. Tax Court.<sup>44</sup> Therefore, filing an NFTL on a relatively small liability, such as \$10,000 or even \$50,000, may open the government to significant expenses. This does not mean the IRS should not file liens to protect the government's interest in the taxpayer's assets or equity in assets. However, the IRS should do it judiciously, after considering all facts and circumstances, and definitely not based merely on the size of the unpaid balance.<sup>45</sup>

***Notices of Federal Tax Lien must be filed in a proper jurisdiction to protect the government's interest in taxpayer assets or priority in bankruptcy.***

Because the IRS does not verify the taxpayer's address or determine where the assets are located before filing a lien, some NFTLs may be filed in the wrong jurisdiction, making them potentially worthless, and stripping the government of its protected interest in taxpayer assets or priority in bankruptcy.<sup>46</sup> The Treasury Inspector General for Tax Administration (TIGTA) repeatedly found that CDP notices were undeliverable or not sent to the taxpayer's last known address.<sup>47</sup> Another TIGTA report estimated that about ten percent of all IRS correspondence with taxpayers was returned as undeliverable.<sup>48</sup> Assuming that the IRS sent the notices to addresses recorded in its databases, and because the IRS does not verify the existence of assets of delinquent taxpayers or the equity in those assets, many NFTL filings may not properly attach to equity in real or personal property of the taxpayer.<sup>49</sup> As a result, these worthless NFTLs harm taxpayers' ability to obtain credit and simultaneously

<sup>44</sup> Litigation creates additional costs for the government, including the time spent by judges and other personnel. For example if the taxpayer succeeds in the Tax Court, the IRS may incur additional administrative costs while releasing or withdrawing the NFTL. If the taxpayer loses, he or she has a right to appeal the case, resulting in additional costs for the government at the circuit court level. Filing an NFTL to collect \$10,000 potentially opens the government up to significant downstream costs as it defends the NFTL in the CDP process. See Keith Fogg, *Systemic Problems With Low-Dollar Lien Filing*, 2011 TNT 194-9 (Oct. 6, 2011).

<sup>45</sup> The "fresh start" initiative increased the NFTL filing threshold from \$5,000 to \$10,000 as discussed above. CPS recommended raising the threshold to \$50,000. CPS at 121-122.

<sup>46</sup> See, e.g., IRM 5.12.2.6(6) (Oct. 30, 2009) ("NFTLs must show the taxpayer's last known address."). A valid NFTL must be generally filed in an office designated by the state where the real property is located (usually the clerk of the court in the county it is located), with the Secretary of State (for personal property where the taxpayer resides at the time of the filing), or with the U.S. District Court (when the state has not designated one office for filing). See generally IRC § 6323(f)(1); Treas. Reg. § 6323(f)-1.

<sup>47</sup> See, e.g., TIGTA, Ref. No. 2011-30-051, *Challenges Remain When Processing Undeliverable Mail and Preventing Violations of Taxpayers' Rights During the Lien Due Process* (May 13, 2011); TIGTA, Ref. No. 2010-30-072, *Actions Are Needed to Protect Taxpayers' Rights During the Lien Due Process* (July 9, 2010); TIGTA, Ref. No. 2009-30-089, *Additional Actions Are Needed to Protect Taxpayers' Rights During the Lien Due Process* (June 16, 2009). IRC § 6320 requires the IRS to notify taxpayers in writing within five business days of the filing of an NFTL. The last known address is the one shown on the most recently filed and properly processed tax return, unless the IRS is notified of a different address.

<sup>48</sup> TIGTA, Ref. No. 2010-40-055, *Current Practices Are Preventing a Reduction in the Volume of Undelivered Mail 2* (May 14, 2010). See also National Taxpayer Advocate 2010 Annual Report to Congress 221-234 (Most Serious Problem: *The IRS Has Not Studied or Addressed the Impact of the Large Volume of Undelivered Mail on Taxpayers*).

<sup>49</sup> Most lien notices are mailed to taxpayers by certified or registered mail rather than being delivered in person. The IRS Automated Lien System (ALS) generates a certified mail list that identifies each notice to be mailed. The stamped certified mail list is the only documentation the IRS has that certifies the date when the notices were mailed. TIGTA, Ref. No. 2011-30-051, at 1-2. For example, 10,370 or about four percent of all CDP lien notices mailed in FY 2011 by the Cff were returned as undeliverable. IRS, CDW, Individual MasterFile (IMF) and Business MasterFile (BMF) Transaction History Tables, FY 2011. The IRS Automated Collection System (ACS), which files most NFTLs, does not track issued CDP lien notices at all. TAS estimates that the number and percent of undeliverable CDP lien notices is higher for ACS because ACS employees generally do not maintain contact with taxpayers. See, e.g., IRS, Collection Activity Report, NO-5000-C23, *Collection Workload Indicators Reports* (Sept. 2010) (Of the 1,096,376 NFTLs filed in FY 2010, 554,331 (50.6 percent) were filed by the ACS.).

hinder the IRS's ability to collect revenue.<sup>50</sup> The IRS should conduct a statistically valid study of how many liens are filed in the right jurisdictions and actually attach to the delinquent taxpayers' assets. In any case, the fact that many NFTLs may be improperly filed undermines the case for filing without verifying the existence and location of assets and contacting the taxpayer.

*The IRS must rethink its policy of filing NFTLs against CNC taxpayers.*

As discussed in detail in prior reports to Congress and Taxpayer Advocate Directives issued to IRS executives,<sup>51</sup> there is no sound business reason for the current policy of filing NFTLs against CNC taxpayers (who in most cases have no assets), both when the IRS cannot locate or contact the taxpayer and when the taxpayer is experiencing an economic hardship.<sup>52</sup> In many cases, an IRS employee may have talked to the taxpayer and evaluated his or her financial information or other evidence of financial difficulty (including a medical hardship) prior to reporting the taxpayer's account as CNC (Unable to Pay - Hardship).<sup>53</sup> A prior TAS study of collection payment data from a subset of taxpayers in CNC (hardship) status also shows that approximately 20 percent of the total dollars collected from these taxpayers are attributable to NFTLs.<sup>54</sup> At the same time, refund offsets — which do not require an NFTL — comprise about 59 percent of the total dollars collected and about half of all payment transactions for this group.<sup>55</sup> Therefore, the NFTL filing may harm the taxpayers and the government at the same time.<sup>56</sup>

*Lien filings should employ sound judgment.*

Sound business judgment suggests the IRS should defer filing an NFTL against a cooperative taxpayer who responds to IRS requests, complies with current filing and payment requirements, and tries to resolve past debts through collection alternatives (*e.g.*, an installment agreement (IA) or offer in compromise (OIC)). It is true that the general economic environment or individual circumstances of taxpayers suffering an economic hardship

<sup>50</sup> Undeliverable CDP notices also violate an important statutory right to a CDP hearing. TIGTA repeatedly found potential violations of CDP rights because the IRS did not timely notify taxpayers or their representatives or failed to deliver CDP notices to the taxpayer's last known address. See, *e.g.*, TIGTA, Ref. No. 2011-30-051, at 2.

<sup>51</sup> See TAD 2010-1; Memorandum for Steven T. Miller, Deputy Commissioner for Services and Enforcement, from Nina E. Olson, National Taxpayer Advocate, *Sustaining Taxpayer Advocate Directive 2010-1* (Mar. 31, 2010). See also National Taxpayer Advocate 2010 Annual Report to Congress 302-310; National Taxpayer Advocate 2009 Annual Report to Congress 17-40.

<sup>52</sup> IRM 5.19.4.5.2 (May 20, 2011).

<sup>53</sup> See IRM 5.19.1.7.1.5 (Sept. 7, 2011); Policy Statement P-5-71, IRM 1.2.14.1.14 (Nov. 19, 1980). See also IRM 5.16.1.1 (Apr. 29, 2011) and IRM 5.16.1.2.9 (Apr. 29, 2011). The basis for a hardship determination is from information about the taxpayer's financial condition provided on Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals*, or Form 433-B, *Collection Information Statement for Businesses*. See also IRM 5.15.1, *Financial Analysis Handbook* (Oct. 2, 2009).

<sup>54</sup> National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 1-18 (TAS Research Study: *The IRS's Use of Notices of Federal Tax Lien*).

<sup>55</sup> Pursuant to IRC § 6402(a), the IRS may credit a taxpayer's overpayment to any federal tax liability prior to making a refund. This application of a tax overpayment is called a refund offset.

<sup>56</sup> NFTL filings harm low income and minority taxpayers the most. See, *e.g.*, T. Keith Fogg, *Systemic Problems With Low-Dollar Lien Filing*, 2011 TNT 194-9 (Oct. 6, 2011) (discussing negative effects of NFTL filings on low income taxpayers); Fortune, *The IRS's Problem with Minorities* (Dec. 2, 2010) (citing study entitled *IRS Enforcement's Impact on Minority Communities*, exclusively conducted for Fortune by Thomas M. Evans, CEO of TaxLifeboat, a firm that advises taxpayers on resolving their problems with the IRS)..

today, or repaying liabilities under an IA, may improve in the future, resulting in equity in assets. At that time, the government might reap some benefit from filing the NFTL.<sup>57</sup> Therefore, a sound and prudent lien and collection strategy would require a regular review of taxpayer information and meaningful lien determinations, such as verifying that the NFTL attaches to assets and does not hamper collection from and future compliance by a generally cooperative taxpayer.

***Lien filings where the taxpayer qualifies for an NFTL withdrawal at the outset under IRC § 6323(j)(1) are counterproductive.***<sup>58</sup>

The National Taxpayer Advocate's guidance to TAS employees advises them to use sound judgment in evaluating the facts and circumstances surrounding the filing of an NFTL in cases involving IAs, OICs, or CNC determinations.<sup>59</sup> When a taxpayer's situation meets one of the IRC § 6323(j)(1) requirements for an NFTL withdrawal, TAS employees are instructed to advocate against the filing of an NFTL. This "reverse" analysis of NFTL withdrawal criteria before filing the lien will save IRS resources and alleviate unnecessary harm to taxpayers.

***A Notice of Federal Tax Lien determination should involve human review.***

The National Taxpayer Advocate believes the IRS should adhere to its longstanding policy and the spirit of the IRS Restructuring and Reform Act of 1998, and file NFTLs only after an individual lien filing determination is made by an employee and is reviewed and approved by his or her immediate supervisor.<sup>60</sup> This does not mean the IRS cannot use technology in selecting NFTL cases for human review and base its lien filing determinations on meaningful criteria, as discussed above.<sup>61</sup> TAS offers its assistance in developing such a meaningful lien filing determination algorithm.

<sup>57</sup> The IRS does have the tools necessary to determine the existence and the value of assets or equity in assets, such as Information Returns Program (IRP) data (which provide verifiable third party documentation), and Accurint (to confirm real estate, business property, and motor vehicle records). The IRP allows IRS employees to request either on-line or hardcopy Information Returns Processing (IRP) transcripts from the Information Returns Master File (IRMF), e.g., Form 1098, *Mortgage Interest Statement* (demonstrating home ownership) or Form 1099-INT, *Interest Statement* (demonstrating asset ownership). Accurint is a service provided by Lexis-Nexis, with which the IRS has an unlimited annually renewable contract. See Accurint, <http://www.accurint.com> (last visited Oct. 31, 2011).

<sup>58</sup> IRC § 6323(j)(1) provides the NFTL may be withdrawn when one of the following criteria is met: (A) The IRS filed the NFTL prematurely or otherwise not in accordance with procedures; (B) The taxpayer entered into an installment agreement to satisfy the liability (unless the IA provides otherwise); (C) The withdrawal would facilitate collection; or (D) The withdrawal is in the best interests of the taxpayer (as determined by the National Taxpayer Advocate) and the United States.

<sup>59</sup> National Taxpayer Advocate, *Interim Guidance Memorandum*, Control No. TAS-13.1-0310-003 (Mar. 31, 2010). For a copy of this memorandum, see National Taxpayer Advocate Fiscal Year 2011 Objectives Report to Congress, Appendix IX, available at <http://www.irs.gov/pub/irs-utl/nta2011objectivesfinal.pdf>.

<sup>60</sup> Section 3421 of RRA 98 provides that, where appropriate, a supervisor review the proposed lien filing, considering the amount due and the value of the taxpayer's assets. RRA 98, Title III, § 3421, Pub. L. No. 105-206, 112 Stat. 685, 758 (1998). IRS Policy Statement 5-47 states: "...All pertinent facts must be carefully considered as the filing of the notice of lien may adversely affect the taxpayer's ability to pay and thereby hamper or retard the collection process." IRM 1.2.14.1.13 (Oct. 9, 1996).

<sup>61</sup> Some of these factors include: existence and value in assets, compliance history, reasons for noncompliance, potential to hamper collection, undue harm to taxpayer that reduces collection potential, cooperation of the taxpayer, willingness to resolve the liability, payment before collection statute expiration date (CSED), etc. National Taxpayer Advocate, *Interim Guidance Memorandum*, Control No. TAS-13.1-0310-003 (Mar. 31, 2010). See also Keith Fogg, *Systemic Problems With Low-Dollar Lien Filing*, 2011 TNT 194-9 (Oct. 6, 2011).

### **TAS Collaboration with the Enterprise Collections Strategy Function May Provide a Strong Foundation for Improvements to NFTL Filing Policies.**

The IRS recently established a new Enterprise Collection Strategy (ECS) office within the SB/SE division.<sup>62</sup> As stated above, TAS works closely with the new office and is represented on the Collection Governance Council, overseeing the IRS Collection strategy. The National Taxpayer Advocate is pleased with the IRS's interest in basing any future policy decisions on a data-driven approach.<sup>63</sup> The IRS's commitment to such a collaborative effort with TAS on developing meaningful NFTL filing criteria may lay a foundation for improved future compliance, increased revenue, and minimization of economic harm for financially struggling taxpayers.<sup>64</sup>

## **CONCLUSION**

TAS research studies have demonstrated empirically that current IRS lien filing policies are not working properly from either the taxpayer or the IRS perspectives. These policies actively and unnecessarily harm taxpayers and discourage current and future compliance, without increasing revenue. The IRS should carefully redesign these policies using meaningful lien filing criteria discussed above. In conclusion, the National Taxpayer Advocate offers these preliminary recommendations:

1. Based on the results of the TAS study and in collaboration with the National Taxpayer Advocate, develop new, meaningful NFTL filing determination criteria based on thorough review of objective factors, such as the existence and value of the taxpayer's equity in assets, compliance history, reasons for noncompliance, effect on collection potential, harm to the taxpayer and his or her ability to comply in the future, prior contact and cooperation of the taxpayer, willingness to resolve the liability (including through collection alternatives), payment before the collection statute expiration date (CSED), assurance that the NFTL is filed in proper jurisdiction, etc. These new criteria will replace the current policy of automatically filing liens based on a dollar threshold of unpaid liability.
2. Discontinue NFTL filing on currently not collectible taxpayers based on dollar threshold of unpaid liability, and instead make a lien filing determination at the time of the CNC determination.
3. Replace the mandatory NFTL filing on CNC taxpayers and taxpayers with no assets with a system of subsequent filing determinations based on periodic monitoring of

<sup>62</sup> Enterprise Collection Strategy Organization Chart (Oct. 30, 2011).

<sup>63</sup> See, e.g., Memorandum for Nina E. Olson, National Taxpayer Advocate, from Steven T. Miller, on Taxpayer Advocate Directives 2010-1, 2010-2, and 2010-3 (June 10, 2010).

<sup>64</sup> The meaningful criteria should balance the need to protect the government's interests in the taxpayer's assets with a corresponding concern for the financial harm the lien will create for that taxpayer. An NFTL filing determination should be made by a revenue officer after considering all facts and circumstances of a particular taxpayer.

whether the taxpayers have acquired assets or their financial situations have improved, using information from Accurant and IRS internal databases.

4. Require managerial approval for NFTL filings in cases where no attempted personal contact was made or the notice to the taxpayer was returned as undeliverable.

### IRS COMMENTS

The IRS is committed to assisting taxpayers with their voluntary filing and payment responsibilities. We must balance the interests of taxpayers with our responsibility to protect the government's interest when federal taxes are not paid. Several steps are taken through our normal processes prior to consideration of a Notice of Federal Tax Lien. Before an NFTL is filed, an assessment must be made, demand for payment must be made, and the taxpayer must have neglected or refused to pay. A lien protects the government's interest by publicly recording the debt owed by the taxpayer as a notice to possible future creditors and establishes a priority among other secured creditors. The lien attaches to property currently owned and to property the taxpayer may acquire in the future. In order to protect the government's interest, filing of a lien is necessary in many cases even if specific assets have not been identified.

As noted by the National Taxpayer Advocate, the IRS has made changes to its NFTL filing policies through Fresh Start initiatives. In February 2011, IRS announced that it significantly increased the dollar threshold when liens are generally filed. Additionally, the IRS also modified procedures to make it easier for taxpayers to obtain lien withdrawals. Changes to both the lien threshold and lien withdrawals were coordinated with the National Taxpayer Advocate staff prior to implementation. IRS employees also have the discretion to not file liens if it would hamper collection of the taxes owed, there is doubt as to the liability, or forthcoming information could lead to either of the above. The IRS continually monitors whether additional changes in this area are appropriate.

The National Taxpayer Advocate relies on several data sources in reaching conclusions in the draft report. The IRS has not yet been provided the study in which the National Taxpayer Advocate states that the results show taxpayers against whom the IRS has filed an NFTL tend to be less compliant in tax filing and payment in subsequent tax years. We are interested in these findings and would appreciate the opportunity to analyze the results of this study. The National Taxpayer Advocate's position also relies on an IRS focus group report. The IRS focus group report did demonstrate that the IRS could improve communication of procedures in handling delinquent accounts thereby dispelling false perceptions of the overall collection process. To this end, we are continually taking steps to improve our communications to taxpayers and practitioners. The NFTL was included as a topic in the National Tax Forums this year. We have also updated the lien web page on IRS.gov. As resources become available, additional educational videos will be developed and posted.

The National Taxpayer Advocate also states some IRS lien notice filings may not make business sense due to downstream costs. The IRS is unlike a private sector creditor who

can extend or deny credit based on a risk analysis. In the case of the IRS, filing lien notices to establish creditor standing is the only legal means the IRS has to protect the American taxpaying public's interest.

The National Taxpayer Advocate contends that NFTL filing does not produce revenue. It should be noted that the decrease in overall collection revenue is discussed without regard to factors such as the current downturn in the economy, which are significant to any analysis. In addition, with respect to the 2009 study by the National Taxpayer Advocate regarding Designated Payment Codes, this study concluded that only payments with a lien DPC were attributable to the filing of the lien. However, most remittances are received in a bulk processing operation and are not assigned a DPC. In addition, taxpayers are rarely explicit in describing their reasons for sending a payment. Therefore, we believe that the DPC process is not an appropriate gauge to demonstrate the effectiveness of the NFTL in promoting payment. It could be argued, because of the lien notice's impact, any payment received after the notice is filed would be directly or indirectly attributable to the lien.

The IRS has commissioned several studies by the SB/SE Research function regarding NFTL filing policies. In June 2011, SB/SE Research published the results of the study, *Estimating the Impact of Federal Tax Lien Filing on BMF and IMF Cases Assigned to the Queue*. This study found lien filing has the potential to increase full and partial resolution for both IMF and BMF cases in the queue.

The National Taxpayer Advocate states that a significant number of NFTLs are filed incorrectly, citing TIGTA reports on undelivered mail. A review of the TIGTA report findings stated that IRS consistently complies with legal and procedural guidelines. In TIGTA report 2010-30-072, TIGTA found an error rate of less than 2.5 percent in mailing lien notice filing due process rights to the last known address. TIGTA commented that the IRS needs to better protect the government's interest in regards to delinquent taxes. In fact, in a separate report, TIGTA stated if liens are not filed when accounts are closed as currently not collectible, the probability of any future collection on the cases is reduced.<sup>65</sup>

The IRS recognizes the need to continually provide information for taxpayers and practitioners about what it means to have a lien, what it means when a lien notice is filed, what can be done about it, and who to contact. To that end, we have revised the instructions and provided an application form to request a release of an NFTL when the NFTL is filed in order to address concerns regarding selling and refinancing property. In March 2011, we also posted to IRS.gov a video support guide to assist with the release of lien application forms and the process.

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

<sup>65</sup> Report 2011-30-051 (May 13, 2011).

The IRS has initiated several research studies (including one in conjunction with the National Taxpayer Advocate) to determine the effectiveness of lien notice filing. We will continue to utilize the findings from these and future studies when considering Internal Revenue Manual (IRM) and policy changes to ensure employees are filing appropriate and effective NFTLs.

In some cases, the IRS makes the NFTL determination concurrently with a CNC determination. However, with Field Collection assigned cases, the notice filing determination is generally made several months (and sometimes years) prior to the CNC determination. The CNC determination is based on collection information and supporting documentation substantiating the reporting of a case as CNC.

We will take into account the views included in the report, but anticipate that institution of a monitoring system on CNC cases to prompt lien notice filing if it becomes necessary would not be effective or efficient. In addition to significant cost of revisiting the NFTL decision multiple times, relying on an arbitrary timeframe for performing the subsequent reviews may not be sufficient to protect the government's interest. For instance, during this period, a taxpayer who has acquired assets may file bankruptcy and the government claim will not be protected.

While the IRS agrees that appropriate efforts should be made to contact taxpayers prior to NFTL filing, at this time, we do not believe it is appropriate to require managerial approval in cases where no attempted personal contact was made. Generally, the IRS sends multiple letters for each tax period owed. In most cases, the IRS further attempts to make contact via telephone or in person. It is normally after the taxpayer has had several opportunities to respond, and did not voluntarily resolve their account, that a Notice of Federal Tax Lien will be filed, if it meets the filing threshold.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate commends the IRS for the changes in the lien filing procedures through the Fresh Start Initiative and for collaborating with the TAS research function on studies to determine the effectiveness of NFTL filings.

In the months leading up to the printing of this report, the National Taxpayer Advocate shared the data and methodology of the recent TAS Lien Study (published in its entirety in Volume 2 of this report) with SB/SE Research and IRS National Office Research staff.<sup>66</sup> She also personally discussed the methodology and findings of the study with the IRS Commissioner, the SB/SE Commissioner, the SB/SE Director of Collection Field Function, and Enterprise Collection Strategy leadership. We will continue to review and analyze the results of this study with the IRS.

The 2012 phase of this groundbreaking, longitudinal lien study will investigate when NFTLs are likely to be most effective, and we invite the IRS to collaborate with us in the design and analysis of this phase. Possible areas of future research, among others, include the impact of lien filing on taxpayers in CNC 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.<sup>67</sup>

In conducting our lien study, we included in the models independent variables that capture all the factors that we believe significantly influence the model outcome variables. Additional modeling to determine the interaction between these variables, tax compliance, and lien filing will provide the IRS with valuable empirical data upon which to base informed lien-filing policies. For example, to model the tax compliance behavior of delinquent taxpayers, the models include the factors that we believe may impact a taxpayer's compliance. The models have independent variables for taxpayer characteristics and indicators that reflect IRS collection activities associated with the taxpayer's liability. Individual taxpayer characteristics include marital status, number of exemptions, and an age category. Also, income information is included in several forms such as total positive income, average total positive income, presence of the earned income tax credit (EITC), and business or partnership income.

Since taxpayer compliance may be influenced by IRS audit and collection activities, the models include independent variables that capture whether the taxpayer has undergone an

<sup>66</sup> See TAS Research Study: *Estimating the Impact of Liens on Taxpayer Compliance Behavior and Income*, Vol. 2, *infra*.

<sup>67</sup> In prior research, TAS found that most payments for lien taxpayers were attributable to sources other than the lien, such as refund offsets. See National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 1-18 (*The IRS's Use of Notices of Federal Tax Lien*).

audit, as well as information about important collection-related activities, such as whether the taxpayer had an installment agreement or defaulted on an IA, whether the taxpayer was placed in CNC status, or whether the IRS levied on the taxpayer. We have also captured whether the taxpayer filed for bankruptcy.<sup>68</sup>

With these studies in hand, TAS is committed to working with the IRS on new, meaningful NFTL filing criteria, based on a thorough review of objective factors, to replace the current policy of automatically filing liens based on a dollar threshold of unpaid liability. These objective factors may include the existence and value of the taxpayer's equity in assets, compliance history, reasons for noncompliance, effect on collection potential, harm to the taxpayer and his or her ability to comply in the future, prior contact and cooperation of the taxpayer, willingness to resolve the liability (including through collection alternatives), payment before the collection statute expiration date (CSED), and assurance that the NFTL is filed in the proper jurisdiction.

While pleased with recent improvements in the NFTL withdrawal process and communications with taxpayers and practitioners, the National Taxpayer Advocate remains concerned about the systemic filing of liens without full consideration of facts and circumstances. The IRS files almost half of its liens through the Automated Collection System, and files over two-thirds of these without any significant employee review of the cases.<sup>69</sup> The National Taxpayer Advocate does not believe the IRS should be precluded from filing NFTLs, but it should use this powerful collection tool judiciously as warranted by the circumstances of the delinquency.<sup>70</sup>

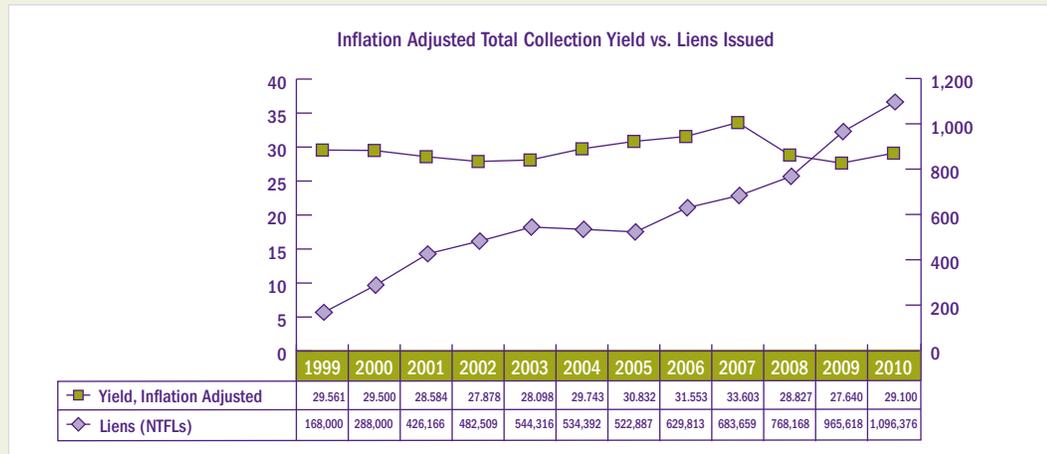
While NFTL filings fell to an all-time low after the enactment of the Revenue and Reconciliation Act of 1998, they have since increased, and have risen precipitously since 2005. In fact, the 2011 volume of 1,042,230 filings is about six times the number for 1999. The following chart shows the volume of IRS lien filings and the total dollars collected since that year.

<sup>68</sup> For a detailed discussion of the models and independent variables used in the recent TAS lien study, see TAS Research Study: *Estimating the Impact of Liens on Taxpayer Compliance Behavior and Income*, Vol. 2, *infra*.

<sup>69</sup> IRS, Collection Activity Report, NO-5000-C23, *Collection Workload Indicators* (Oct. 11, 2011). Of the 1,042,230 NFTLs filed in FY 2011, 45.6 percent were filed by the ACS Automated Collection System (ACS) *Customer Service Activity Reports (CSAR), FY 2011 BOD report and Support Site Report* (Oct.1, 2011)

<sup>70</sup> For a more detailed discussion, see National Taxpayer Advocate 2010 Annual Report to Congress 302-310; National Taxpayer Advocate 2009 Annual Report to Congress 17-40.

**FIGURE 1.6.1, Inflation-Adjusted Total Yield vs. Liens Issued<sup>71</sup>**



As illustrated above, overall inflation-adjusted collection revenue has not kept pace with the growth in lien filings.<sup>72</sup> While other economic conditions certainly affect the total collection yield, the fact that increased lien filings do not necessarily increase collections makes the practice of filing an NFTL questionable in various situations.

The IRS’s statement “that the DPC process is not an appropriate gauge to demonstrate the effectiveness of the NFTL in promoting payment” is rather disingenuous. For the third consecutive year, the National Taxpayer Advocate raises concerns about the IRS’s inability to accurately track the source of *subsequent, post-assessment* tax payments received on past due accounts.<sup>73</sup> The IRS’s own internal guidance interprets that DPCs are “*congressionally mandated and will be accumulated on a national basis to determine the revenue effectiveness of specific collection activities.*”<sup>74</sup> DPCs are designed to provide the IRS and outside stakeholders with meaningful information regarding the revenue outcomes of IRS compliance activities. DPCs are also very important for gauging the IRS’s performance in *objective, quantifiable, and measurable* terms. The IRS’s use of the DPCs, however, does not provide good data for use in this manner. A TAS analysis of IRS payment source data has found that the DPC is not present on payment vouchers in 81 percent of all post-assessment tax payments received in 2009. Even with transaction codes that require DPCs, about 75 percent of all entries either had no DPC or defaulted to DPCs of “00” (undesignated payment) or “99” (miscellaneous). Thus, in most cases, the IRS does not know and

<sup>71</sup> IRS, *IRS Data Books, Table 16, Delinquent Collection Activities, 1999-2010*; IRS, Collection Activity Report NO-5000-23, *Collection Workload Indicators* (Oct. 11, 2011).

<sup>72</sup> The inflation-adjusted totals reflect the yearly total collection yields adjusted to 2010 dollars using the U.S. Consumer Price Index-All Urban 2010, U.S. Bureau of Labor Statistics.

<sup>73</sup> National Taxpayer Advocate 2010 Annual Report to Congress 302-310; National Taxpayer Advocate 2010 Annual Report to Congress 250-266; National Taxpayer Advocate 2009 Annual Report to Congress 17-40; National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 1-18. Most pre-filing, voluntary payments are already identifiable from their source, e.g., payments with return (TC 610); federal tax deposits (TC 650); estimated tax payments (TC 660), etc.

<sup>74</sup> IRM 5.1.2.8.1.3, *Identify the Event That Resulted in a Payment* (Aug. 15, 2008) (emphasis added).

cannot determine what event or action prompted the subsequent payment on a past due account. The IRS also has not taken action on the National Taxpayer Advocate recommendation to link each subsequent payment to specific IRS enforcement activities and service initiatives.<sup>75</sup>

The National Taxpayer Advocate also disagrees with the IRS's statement that "unlike a private sector creditor [it cannot make lien filing determinations] based on a risk analysis." It is also not true that the lien filing is the "only legal means the IRS has to protect the American taxpaying public's interest." Unlike a private creditor, the IRS has a number of powerful collection tools at its disposal, including levies and seizures. In the current budget environment, the IRS can and should employ the most cost-effective methods of collecting revenue. Risk analysis, verification of address and assets, and elimination of downstream costs may save millions of dollars in unnecessary filing fees, re-work, and litigation. The IRS's role as the nation's tax administrator requires it to use public resources responsibly, and maximize revenue collection without imposing undue burdens on taxpayers.

In addition, as stated in prior reports to Congress, an NFTL filing does not necessarily result in increased collection in bankruptcy.<sup>76</sup> The IRS itself acknowledges that in CNC cases, the amount of the secured claim in bankruptcy would be at or close to zero.<sup>77</sup> FY 2011 data clearly support this premise: the IRS collected more in bankruptcy proceedings on *unsecured* priority claims than on secured claims.<sup>78</sup> Therefore, it would be prudent for the IRS to make the NFTL determination concurrently with a CNC determination. In Field Collection cases, when NFTL determinations are made several months prior to CNC determination, the IRS can use its discretionary authority to withdraw the NFTL concurrently with making the CNC determination based on financial information and documentation substantiating the CNC status.

Instituting a monitoring system for CNC and no-assets cases would improve the efficiency of NFTL filings and save IRS resources. The IRS can and should use technology to identify assets and prompt a review of a case when the taxpayer acquires an asset or his financial situation improves. The CNC process has a built-in monitoring system, based on the dollar threshold and closing code established for review of the account. If a taxpayer exceeds that amount, the IRS can reactivate the account and make a new NFTL determination based on the taxpayer's improved circumstances.

<sup>75</sup> For a detailed discussion of designated payment codes, see National Taxpayer Advocate 2010 Annual Report to Congress 250-266 (Most Serious Problem: *The IRS Should Accurately Track Sources of Balance Due Payments to Determine the Revenue Effectiveness of Its Enforcement Activities and Service Initiatives*).

<sup>76</sup> See, e.g., National Taxpayer Advocate 2010 Annual Report to Congress 302-310; Taxpayer Advocate Directive 2010-1 (Mar. 31, 2011).

<sup>77</sup> See IRM 5.16.1.2.9(1) (stating that "[g]enerally, these [CNC hardship] cases involve no income or assets, no equity in assets or insufficient income to make any payment without causing hardship."). IRM 5.16.1.2.9(1), Hardship (Apr. 29, 2011).

<sup>78</sup> IRS, Collection Activity Report NO-5000-31, *IMF Report of Bankruptcies* (Sep. 28, 2011), Total - All Chapters, line 2.1. In FY 2011, the total collection for all chapters showed \$253,420,479 collected from unsecured priority claims and \$53,105,549 collected from secured claims. The IRS also collected \$33,283,222 from general unsecured claims. For definitions, see 11 U.S.C. §§ 506(secured claim); 507(a)(8) (priority claim).

The National Taxpayer Advocate agrees with TIGTA that the IRS needs to better protect the government's interests. We contend that better research of the taxpayer's true last known address and personal contact with the taxpayer would provide more up-to-date information to ensure that the IRS files the NFTL with the most current address and in the proper jurisdiction to ensure legal attachment to assets.

The National Taxpayer Advocate believes an NFTL filing must have a manager's approval when the IRS has not made personal contact with the taxpayer and its notices have been returned as undeliverable. This level of approval should ensure that the benefit to the government outweighs the harm to the taxpayer and that the NFTL will attach to assets.

## Recommendations

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

1. 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.
2. Based on the results of the TAS study and in collaboration with the National Taxpayer Advocate, develop new, meaningful NFTL filing determination criteria based on thorough review of objective factors, such as the existence and value of the taxpayer's equity in assets, compliance history, reasons for noncompliance, effect on collection potential, harm to the taxpayer and his or her ability to comply in the future, prior contact and cooperation of the taxpayer, willingness to resolve the liability (including through collection alternatives), payment before the collection statute expiration date, and assurance that the NFTL is filed in the proper jurisdiction. These new criteria will replace the current policy of automatically filing liens based on a dollar threshold of unpaid liability.
3. Discontinue NFTL filing on currently not collectible taxpayers based on the dollar threshold of unpaid liability, and instead make a lien filing determination at the time of the CNC determination.
4. Replace the mandatory NFTL filing on CNC taxpayers and taxpayers 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, using information from Accurint and IRS internal databases.
5. Require managerial approval for NFTL filings in cases where the IRS has not made personal contact with the taxpayer or the notice to the taxpayer was returned as undeliverable.

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

## 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

### WHY ADDRESS TAX ISSUES FACING INTERNATIONAL TAXPAYERS?

In recent years, globalization has pushed an increasing number of taxpayers (including small- and medium-sized businesses and individuals) to seek economic opportunities abroad.<sup>1</sup> It also has increased competition among tax administration agencies for tax bases and sources of revenue. The revenue generated depends on governments' administrative capacities to collect taxes, and more importantly, on taxpayers' willingness and ability to comply. For this reason, 40 economies made it easier to pay taxes last year.<sup>2</sup> In contrast, a recent World Bank report ranks the United States 66<sup>th</sup> in time spent to comply and 62<sup>nd</sup> in the ease of paying taxes among 183 countries surveyed.<sup>3</sup>

International taxpayers who are subject to complex U.S. tax rules and reporting requirements can be grouped into four categories:

- 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.<sup>4</sup>

The complexity of international tax law, combined with the administrative burden placed on these taxpayers, creates an environment where 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. For some U.S. taxpayers abroad, the tax requirements are so confusing and the compliance burden so great that they give up their U.S. citizenship.<sup>5</sup>

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.<sup>6</sup> Yet while the IRS has substantially stepped up and invested hundreds of millions of dollars

<sup>1</sup> Memorandum for Secretary Geithner from J. Russell George, Treasury Inspector General for Tax Administration, *Management and Performance Challenges Facing the Internal Revenue Service for Fiscal Year 2011* 13 (Oct. 15, 2010).

<sup>2</sup> The World Bank, The International Finance Corporation (IFC), and PricewaterhouseCoopers (PwC), *Paying Taxes 2011, The Global Picture* (2011).

<sup>3</sup> *Id.* The report studied the impact of tax systems on businesses in terms of both tax cost and compliance burden.

<sup>4</sup> See, e.g., IRS, Small Business/Self-Employed Division (SB/SE) Research – Philadelphia, Project # 05.02.001.03, International Taxpayer Research Project 7 (Aug. 2003).

<sup>5</sup> National Taxpayer Advocate meeting with the U.S. Ambassador to Switzerland (Feb. 4, 2011). See also Brian Knowlton, *More American Expatriates Give Up Citizenship*, N.Y. Times, Apr. 25, 2010; Helena Bachmann, *Why More U.S. Expatriates Are Turning In Their Passports*, Time World, Apr. 20, 2010.

<sup>6</sup> IRS, Wage & Investment Division (W&I) Research & Analysis, *Understanding the International Taxpayer Experience: Service Awareness, Use, Preferences, and Filing Behaviors, Research Study Report* (Feb. 2010).

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in international enforcement programs, it has not adequately improved taxpayer services that would foster compliance.<sup>7</sup>

Compliance challenges facing international taxpayers include:

- The overwhelming complexity of international tax law;
- The complexity and administrative detail of often duplicative international reporting requirements;
- Steep penalties that may be disproportionate to tax liability;
- The IRS's focus on international tax enforcement without adequate coordination or a corresponding increase in service; and
- The lack of targeted taxpayer service for each of the four groups of international taxpayers, which leads to confusion, errors, and higher compliance costs for this population.

## ANALYSIS

### Background: International Tax Administration Affects Millions of Taxpayers.

Globalization makes international markets and investments more accessible to small businesses and individuals.<sup>8</sup> In fiscal year (FY) 2010 alone, approximately 6.4 million foreign individuals were issued nonimmigrant U.S. visas, and 1.2 million aliens obtained legal permanent resident status.<sup>9</sup> Over 100 million U.S. citizens have valid passports, including over 13 million Americans who received passports to travel abroad in FY 2010.<sup>10</sup> An estimated five million to seven million American citizens reside abroad.<sup>11</sup>

According to the Small Business Administration, from 2003 to 2010, U.S. small businesses' exporting activity increased about 80 percent to account for nearly \$500 billion in annual sales and about 30 percent of America's export revenues.<sup>12</sup> In FY 2007, the most recent year for export data by firm size, 259,400 known small business exporters sold \$311.7

<sup>7</sup> The IRS requested and received approximately \$249 million for international enforcement in FYs 2010 and 2011. See IRS, *The Budget in Brief, FY 2010 and FY 2011*. See also Pub. L. No. 111-117 (Dec. 16, 2009); Pub. L. No. 112-10 (Apr. 15, 2011). See, e.g., Reuters, *Deutsche Bank U.S. Tax Fraud Deal Opens Floodgates* (Dec. 22, 2010) (reporting Deutsche Bank's \$553.6 million and UBS's \$780 million settlement with the IRS). See also National Taxpayer Advocate 2009 Annual Report to Congress 134-154.

<sup>8</sup> Michael Danilack, *Deputy Commissioner (International), IRS Large Business and International Division, The Impact of Globalization on Tax Administration*, panel presentation, 2010 IRS Research Conference (Oct. 2010).

<sup>9</sup> U.S. Dept. of State, *Immigrant and Nonimmigrant Visas Issued at Foreign Service Posts FYs 2006 – 2010*, [www.travel.state.gov](http://www.travel.state.gov) (last visited July 28, 2011); U.S. Dept. of Homeland Security, Office of Immigration Statistics, *Persons Obtaining Legal Permanent Resident Status: FYs 1820 to 2010*, <http://www.dhs.gov/files/statistics/immigration.shtm> (last visited July 15, 2011).

<sup>10</sup> U.S. Dept. of State, *Passport Statistics*, at [www.travel.state.gov](http://www.travel.state.gov) (last visited July 28, 2011).

<sup>11</sup> Cf. IRS website, *Reaching Out to Americans Abroad* (Apr. 2009), and W&I Research Study Report, *Understanding the International Taxpayer Experience: Service Awareness, Use, Preferences, and Filing Behaviors* (Feb. 2010) (citing U.S. Department of State data). This number does not include U.S. troops stationed abroad.

<sup>12</sup> Karen Gordon Mills, Administrator of the U.S. Small Business Administration (SBA), *Taking Your Small Business Customers International* (Oct. 15, 2010), <http://www.sba.gov/administrator/7390/6086> (last visited July 19, 2011).

billion in goods overseas, or 30.2 percent of the total.<sup>13</sup> U.S. business activity by foreign individuals and corporations rose dramatically in recent years, from approximately \$180 billion in tax year (TY) 2000 to almost \$545 billion in TY 2006.<sup>14</sup>

However, the IRS has no way to accurately identify international taxpayers and assess their filing compliance rate. It also lacks a reliable and accurate estimate of the international tax gap.<sup>15</sup>

### **International Provisions Are Among the Most Complicated in the Internal Revenue Code.**

The United States generally taxes U.S. persons on their worldwide income and foreign persons on U.S.-source income that has a sufficient connection to the United States.<sup>16</sup> All U.S. persons, both individuals and businesses, generally must report and are taxed on all income, whether derived in the United States or abroad.<sup>17</sup> U.S. international tax rules are extremely complex, with highly technical requirements and limitations. U.S. individual taxpayers residing abroad have to navigate provisions such as the foreign earned income exclusion, foreign housing allowance, and foreign tax credit.<sup>18</sup> U.S. partnerships and corporations with foreign source income must delve into foreign tax credit (FTC) rules and limitations. U.S. owners of interests in foreign entities also must consider the possible application of the controlled foreign corporation (CFC) and passive foreign investment company (PFIC) rules.<sup>19</sup>

Foreign persons are subject to “net-basis” U.S. tax on income that is “effectively connected” with the conduct of a trade or business in the United States. This income is generally taxed in the same manner and at the same rates as the income of a U.S. person.<sup>20</sup> Foreign persons are also subject to a “gross-basis” U.S. tax at a 30-percent rate on certain categories of non-effectively-connected U.S. source income (*e.g.*, interest, dividends, rents, and royalties)

<sup>13</sup> SBA Office of Advocacy, *The Small Business Economy: A Report to the President* 37 (2010).

<sup>14</sup> IRS, *Statistics of Income Studies of International Income and Taxes* 186, Figure R, *Income Paid to Foreign Persons for Selected Years, 1980-2006*. The inflation-adjusted distributions of U.S.-source income to foreign persons rose about 260 percent from TY 2000 to TY 2006. *Id.*

<sup>15</sup> Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2009-IE-R001, *A Combination of Legislative Actions and Increased IRS Capability and Capacity Are Required to Reduce the Multi-Billion Dollar U.S. International Tax Gap 2* (Jan. 27, 2009); National Taxpayer Advocate 2009 Annual Report to Congress 134-154.

<sup>16</sup> A U.S. person is any citizen or resident of the United States, a domestic partnership or corporation, or any estate or trust that is not considered foreign. Any person who does not fit the definition of a U.S. person is considered a foreign person. See generally Internal Revenue Code (IRC) § 7701.

<sup>17</sup> See generally IRC §§ 1(a), 11(a), 61(a), and 862(a)(5); Treas. Reg. § 1.1-1(b). See also IRC §§ 861, 862, 864, 871, 881, and 882.

<sup>18</sup> See generally IRC §§ 901, 903-904, 908-909, 911, and 912.

<sup>19</sup> See generally IRC §§ 901-904; 951-964; 1291-1298. There are also multiple technically complicated rules and limitations, *e.g.*, interest allocation rules, accumulated earnings tax rules, personal holding company rules, and transfer pricing rules. See also IRC §§ 531-537; 541-547; 864; 482.

<sup>20</sup> IRC §§ 871(b) and 882.

subject to certain exceptions and limitations.<sup>21</sup> The IRS generally collects the gross-basis tax imposed on foreign persons through withholding.<sup>22</sup>

In addition to complex statutory rules for the taxation of foreign income of U.S. persons and U.S. income of foreign persons, the United States has 60 bilateral income tax treaties with 68 countries.<sup>23</sup> Such treaties provide for reduced rates of tax or exemptions from tax for various items of income, but at the cost of increased complexity, especially for persons entitled to claim benefits under more than one bilateral treaty.

### **The Complexity and Administrative Detail of the International Reporting Requirements Are Overwhelming.**

The IRS has 16 publications that address international issues for individuals, totaling 407 pages, with 110 references to other publications totaling 4,491 pages and 137 references to forms totaling 450 pages which have an additional 2,190 pages of instructions. At a minimum, individual international taxpayers spent 25 million hours reviewing and completing TY 2009 forms.<sup>24</sup> Publication 4732, *Federal Tax Information for U.S. Taxpayers Living Abroad*, illustrates the complexity of the filing requirements for individual U.S. taxpayers. The publication refers to at least eight other relevant IRS publications, totaling 563 pages. Further, the additional documents referred to by these eight publications include 4,727 pages of instructions, 667 pages of forms, and another 1,928 pages of form instructions for a total of 7,322 pages.

In addition to returns, these taxpayers may be required to file multiple additional forms, schedules, and information returns.<sup>25</sup> Foreign individuals with U.S. filing obligations cannot file electronically and also must comply with complex reporting requirements.<sup>26</sup> Publication 519, *U.S. Tax Guide for Aliens*, designed for individual foreign taxpayers with U.S. - source income, refers to at least 31 other relevant IRS publications totaling 1,329 pages, 31 forms totaling 87 pages, and 241 pages of form instructions. Thirteen of the 31 publications listed in Publication 519 make 151 references to other publications totaling 5,739 pages, and 244 references to forms totaling 735 pages and 3,204 pages of form instructions, including duplications.

<sup>21</sup> See generally IRC §§ 871 and 881. There is an exception to taxability of interest from certain bank deposits and portfolio obligations. See IRC §§ 871(h)-(j), 881(c)-(d). There are also limitations on interest deductions, known as "thin capitalization" rules, intended to prevent excessive interest deductions by foreign corporations. See IRC § 163(j).

<sup>22</sup> See generally IRC §§ 1441-1446. Withholding rules are extremely technical and basically require the withholding agent (broadly defined as any person) to withhold or be liable for the withholding tax and any applicable penalties and interest.

<sup>23</sup> IRS, *Tax Treaties*, <http://www.irs.gov/businesses/international/article/0,,id=96739,00.html> (last visited July 21, 2011).

<sup>24</sup> IRS, Compliance Data Warehouse (CDW), IRTF\_F1040, IRTF\_F1040NR, and BRTF\_F1042 tables, data extracted cycle 201143. See also IRM 21.8.1.1.3 (Oct. 1, 2009) that refers to IRS Publications 3, 54, 513, 514, 515, 516, 519, 570, 593, 597, 850 series (federal tax terminology glossaries in various languages); 901, 970, 972, 4588, and 4732. The National Taxpayer Advocate acknowledges that form complexity is not only due to the complexity of international tax law rules but also due to the complexity of the transactions.

<sup>25</sup> See, e.g., Forms 1116, 2555 or 2555-EZ; 3520, 3520-A; 5471; 5472; 926; 8865.

<sup>26</sup> For example, in addition to an individual tax return (Form 1040NR or 1040NR-EZ), foreign individuals may have to file Forms 8288-A; 8805; 8833; 8840; and 8843.

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U.S. and foreign entities engaged in cross-border activity are subject to even more complex reporting and withholding requirements.<sup>27</sup> The IRS has 43 publications pertaining to U.S. business taxpayers involved in economic activity abroad, totaling 1,212 pages. These publications refer to additional publications totaling 13,346 pages, 1,500 pages of forms, and another 5,018 pages of form instructions. For example, a U.S. person who engages in foreign activities indirectly through a foreign business entity must comply with burdensome and often duplicative self-reporting requirements.<sup>28</sup> The estimated burden to file a Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*, is about 15 eight-hour work days.<sup>29</sup> Finally, foreign-owned U.S. entities and foreign entities with a U.S. trade or business must file a U.S. tax return and are subject to special rules for reporting transactions with related parties.<sup>30</sup>

#### **Even Inadvertent Noncompliance May Result in Steep Civil and Criminal Penalties.**

International taxpayers who do not comply with these complex requirements are subject to penalties that often are disproportionately high in comparison to the amount of tax involved. Most international penalties relate to information returns and are civil penalties that are not based on the amount of underpayment, including:

- A penalty for failing to file or for filing an incomplete Form 3520, *Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*.<sup>31</sup>
- A penalty for failing to file or for filing an incomplete Form 3520-A, *Information Return of Foreign Trust with a U.S. Owner*.<sup>32</sup>
- A penalty for failing to file Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*.<sup>33</sup>

<sup>27</sup> For Business Master File and Non-Master File reporting and withholding requirements, see IRM 21.8.2 (Oct. 1, 2010) and IRM 21.8.3 (Oct. 1, 2010).

<sup>28</sup> National Taxpayer Advocate 2009 Annual Report to Congress 140.

<sup>29</sup> U.S. persons must report similar information with respect to interests in a controlled foreign partnership or a foreign disregarded entity on Form 8865, *Return of U.S. Persons with Respect to Certain Foreign Partnerships*, and Form 8858, *Information Return of U.S. Persons with Respect to Foreign Disregarded Entities*. The U.S. person capitalizing a foreign corporation with cash as well as other assets and liabilities is required to file Form 926, *Return by a U.S. Transferor of Property to a Foreign Corporation*.

<sup>30</sup> See, e.g., IRS Form 1120-F, and Schedules H, I, P, M-1, M-2, M-3. A foreign partnership may be required to file IRS Forms 1042, 1065, 1065-B, and 8804.

<sup>31</sup> The penalty is 35 percent of the gross reportable amount, except for returns reporting gifts, where the penalty is five percent of the gift per month, up to a maximum penalty of 25 percent of the gift. Only certain large gifts or bequests from certain foreign persons are required to be reported. See generally IRC §§ 6039F and 6048.

<sup>32</sup> The penalty is equal to the greater of five percent of the gross value of trust assets determined to be owned by the United States person or \$10,000. See generally IRC § 6048(b).

<sup>33</sup> Certain United States persons who are officers, directors, or shareholders in certain foreign corporations are required to report information under IRC §§ 6035, 6038, and 6046. The penalty for failing to file each one of these information returns is \$10,000, with an additional \$10,000 added for each month the failure continues beginning 90 days after the taxpayer is notified of the delinquency, up to a maximum of \$50,000 per return. See generally IRC § 6038(b). IRC § 6038(c) further provides for a ten percent reduction of the foreign taxes available for credit under IRC §§ 901, 902, and 960 by a shareholder in a foreign corporation or a partner in a controlled foreign partnership who fails to furnish required information about such foreign entities. The amount of the IRC § 6038(c) penalty must be reduced by the amount of the dollar penalty imposed by IRC § 6038(b).

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- A penalty for failing to file Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*, or to keep certain records regarding reportable transactions.<sup>34</sup>
- A penalty for failing to file Form 926, *Return by a U.S. Transferor of Property to a Foreign Corporation*.<sup>35</sup>
- A penalty for failing to file Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*.<sup>36</sup>
- A penalty for failing to file the Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts* (commonly known as FBAR).<sup>37</sup>
- A penalty for failing to file the new Form 8938, *Statement of Specified Foreign Financial Assets* (commonly known as FATCA).<sup>38</sup> An additional penalty regime for financial asset reporting will apply, and appears to overlap significantly with the disclosure requirements of the FBAR.<sup>39</sup>

In addition to information return penalties, “regular” failure to file, failure to pay, and fraud penalties may apply.<sup>40</sup> Finally, noncompliance may result in criminal charges, including criminal penalties for the failure to file an FBAR and willfully filing a false FBAR.<sup>41</sup>

<sup>34</sup> Taxpayers may be required to report transactions between a 25 percent foreign-owned domestic corporation or a foreign corporation engaged in a trade or business in the United States and a related party as required by IRC §§ 6038A and 6038C. The penalty for failing to file each one of these information returns, or to keep certain records regarding reportable transactions, is \$10,000, with an additional \$10,000 added for each month the failure continues beginning 90 days after the taxpayer is notified of the delinquency.

<sup>35</sup> The penalty for failing to file each one of these information returns is ten percent of the value of the property transferred, up to a maximum of \$100,000 per return, with no limit if the failure to report the transfer was intentional. See *generally* IRC § 6038B.

<sup>36</sup> United States persons with certain interests in foreign partnerships use this form to report interests in and transactions of the foreign partnerships, transfers of property to the foreign partnerships, and acquisitions, dispositions, and changes in foreign partnership interests under IRC §§ 6038, 6038B, and 6046A. Penalties include \$10,000 for failure to file each return, with an additional \$10,000 added for each month the failure continues beginning 90 days after the taxpayer is notified of the delinquency, up to a maximum of \$50,000 per return, and ten percent of the value of any transferred property that is not reported, subject to a \$100,000 limit.

<sup>37</sup> Generally, the civil penalty for willfully failing to file an FBAR can be as high as the greater of \$100,000 or 50 percent of the total balance of the foreign account per violation. See 31 U.S.C. § 5321(a)(5). Non-willful violations that the IRS determines were not due to reasonable cause are subject to up to \$10,000 per violation. See *generally* 31 U.S.C. § 5321(a)(5).

<sup>38</sup> In 2010, Congress enacted the provisions commonly known as Foreign Account Tax Compliance Act (FATCA) as part of the Hiring Incentives to Restore Employment (HIRE) Act, Pub. L. No. 111-147 (Mar. 18, 2010). FATCA requires certain U.S. taxpayers holding foreign financial assets with an aggregate value exceeding \$50,000 to report certain information about those assets on a new form (Form 8938, still in draft) that must be attached to the taxpayer's annual tax return. The statute required reporting for assets held in taxable years beginning after March 18, 2010. In June, 2011, however, reporting required under IRC § 6038D was suspended until Form 8938 is released. See Notice 2011-55, 2011-29 IRB 53. Failure to report foreign financial assets on Form 8938 will result in a penalty of \$10,000 (up to \$50,000 for continued failure after IRS notification). FATCA also will require foreign financial institutions (FFIs) to report to the IRS certain information about financial accounts held by U.S. taxpayers, or by foreign entities in which U.S. taxpayers hold a substantial ownership interest. See *generally* IRC §§ 1471-1474.

<sup>39</sup> The penalty is \$10,000 (and a penalty up to \$50,000 for continued failure after IRS notification), but there is a reasonable cause exception. Further, underpayments of tax attributable to non-disclosed foreign financial assets will be subject to an additional substantial understatement penalty of 40 percent. See *generally* IRC §§ 6038D and 6662(b)(7).

<sup>40</sup> See *generally* IRC §§ 6651, 6662, and 6663.

<sup>41</sup> For example, failing to file an FBAR while violating certain other laws may result in a prison term of up to ten years and criminal penalties of up to \$500,000. Tax evasion may result in a prison term of up to five years and a fine of up to \$250,000. See *generally* 31 U.S.C. § 5322 and IRC §§ 7201 and 7206.

## SUMMARY

The National Taxpayer Advocate is very concerned about the IRS's shift of emphasis away from improving taxpayer service and relieving procedural burdens facing low-profile international taxpayers. Given the overwhelming complexity of the international tax rules and reporting requirements and the potentially devastating penalties for even inadvertent noncompliance, adequate international taxpayer service becomes especially important. Increased international enforcement without substantial improvement in service may lead some voluntarily compliant taxpayers to give up and become noncompliant, slithering off into the cash economy and ultimately increasing the international tax gap.

The National Taxpayer Advocate's past two Annual Reports to Congress examined aspects of compliance challenges and inadequate taxpayer service for international taxpayers.<sup>42</sup> These reports provide a basis for the following administrative and legislative recommendations to help address the needs of diverse international taxpayers:

- Develop a way to identify U.S. taxpayers located or conducting business abroad and assess their filing compliance rate.
- Develop a comprehensive strategy and outreach materials, including a dedicated web page for small businesses, specifically targeting tax problems facing this taxpayer population based on a survey of needs and preferences of U.S. taxpayers abroad.
- Devote more tax attaché posts to taxpayer service, including reinstatement of in-person taxpayer service to U.S. taxpayers residing in Mexico.
- Open case resolution rooms at tax attaché posts and during tax events abroad.<sup>43</sup>
- Implement a pilot of the Pre-filing Agreement Program for small businesses with reduced fees and reduce filing fees for the Advanced Pricing Agreement (APA) program for small businesses with assets of \$10 million or less.
- Provide international toll-free telephone access to the Accounts Management function in Philadelphia and the National Taxpayer Advocate (NTA) toll-free line for U.S. taxpayers in Canada and Mexico, followed by expansion to other countries with large U.S. taxpayer populations.
- Resolve the security issues with the Internet Customer Account Services (ICAS) system and reinstate the "My IRS Account" application, providing taxpayers outside the United States with online access to their accounts.
- Translate the complete IRS website content into Spanish, and translate more IRS forms and publications into other languages.

<sup>42</sup> National Taxpayer Advocate 2009 Annual Report to Congress 134-154 (Most Serious Problem: *U.S. Taxpayers Located or Conducting Business Abroad Face Compliance Challenges*); National Taxpayer Advocate 2008 Annual Report to Congress 141-157 (Most Serious Problem: *Access to the IRS by Individual Taxpayers Located Outside the United States*).

<sup>43</sup> The National Taxpayer Advocate recommends the creation of four Local Taxpayer Advocate positions co-located with current IRS posts in London, Paris, Frankfurt, and Beijing as a part of the revised international taxpayer service strategy, and to fund additional Local Taxpayer Advocate positions as additional attaché offices are opened. See Most Serious Problem: *Globalization Calls for Greater Internal IRS Coordination of International Taxpayer Service, infra*.

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- Implement Estimated Waiting Time (EWT) functionality on IRS toll customer service lines and reduce the wait time for international taxpayers at the Accounts Management function.
- Amend IRC § 904(k)(2)(B) to increase the threshold amount for creditable foreign taxes on qualified passive income to \$500 (\$1,000 if filing a joint return) and index this amount for inflation in \$50 increments.<sup>44</sup>

With respect to international taxpayers, the Most Serious Problems described below are detailed in the following discussions:<sup>45</sup>

- Globalization requires greater internal IRS coordination of international taxpayer service.
- Individual U.S. taxpayers working, living, or doing business abroad need expanded service targeting their specific needs and preferences.
- Small businesses involved in international economic activity require targeted IRS assistance.
- Foreign taxpayers face challenges in fulfilling U.S. tax obligations.
- U.S. taxpayers abroad face challenges with understanding how the IRS will apply penalties to taxpayers who are reasonably trying to comply or return into compliance.

<sup>44</sup> National Taxpayer Advocate 2009 Annual Report to Congress 400-402 (Legislative Recommendation: *Increase the Threshold for the Election to Claim the Foreign Tax Credit Without Filing Form 1116 for Individuals and Index It for Inflation*).

<sup>45</sup> See also Legislative Recommendation: *Allow Individual U.S. Taxpayers Residing Abroad the Option to Choose the Currency of Their Country of Residence as Their Functional Currency*, *infra*.

MSP  
#7**Foreign Taxpayers Face Challenges in Fulfilling U.S. Tax Obligations****RESPONSIBLE OFFICIALS**

Heather C. Maloy, Commissioner, Large Business and International Division  
 Richard E. Byrd Jr., Commissioner, Wage and Investment Division  
 Faris Fink, Commissioner, Small Business/Self-Employed Division  
 Beth Tucker, Deputy Commissioner, Operations Support  
 Frank Keith, Chief, Communications and Liaison

**DEFINITION OF PROBLEM**

Millions of foreign persons enter the United States for personal and business reasons each year.<sup>1</sup> Some of them may be subject to U.S. tax on U.S.-source income and have a U.S. filing obligation.<sup>2</sup> 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.<sup>3</sup> For example, IRS Publication 519, *U.S. Tax Guide for Aliens*, applicable to individual foreign taxpayers with U.S.-source income, refers to at least 31 other relevant IRS publications totaling over 1,300 pages, 31 forms totaling 73 pages, and 251 pages of form instructions. Additionally, 16 of the 31 publications listed in Publication 519 include 160 references to other publications totaling more than 6,200 pages and 269 references to forms totaling over 650 pages and having more than 3,150 pages of form instructions, including duplications. However, the IRS does little to alleviate compliance burdens for this category of international taxpayers.<sup>4</sup> Some of the challenges these taxpayers face include:<sup>5</sup>

- Some nonresidents and their employers may not be aware of or fully appreciate the complex tax rules that apply to nonresident aliens with U.S.-source income;
- Even though some nonresidents earning wages from U.S. employers may have U.S. taxes withheld, they may not know that they must file tax returns or which returns to file;<sup>6</sup>

<sup>1</sup> U.S. Dept. of State, *Immigrant and Nonimmigrant Visas Issued at Foreign Service Posts FYs 2006-2010*, available at [www.travel.state.gov/pdf/FY10Annual-Report-Table1.pdf](http://www.travel.state.gov/pdf/FY10Annual-Report-Table1.pdf) (last visited Nov. 1, 2011).

<sup>2</sup> See generally Internal Revenue Code (IRC) §§ 871-885. There are also foreign individuals and entities that may remain overseas and have U.S.-source income and therefore U.S. filing obligations. However, often it is difficult to identify these taxpayers absent withholding.

<sup>3</sup> See *Preface to International Issues*, *supra*; National Taxpayer Advocate 2010 Annual Report to Congress 3-14. See also *Complexity and the Tax Gap: Making Tax Compliance Easier and Collecting What's Due*, Hearing Before the S. Comm. on Finance, 112th Cong. (June 28, 2011) (statement of Nina E. Olson, National Taxpayer Advocate).

<sup>4</sup> For categories of international taxpayers, see *Preface to International Issues*, *supra*.

<sup>5</sup> See Government Accountability Office (GAO), GAO-10-429, *IRS May Be Able to Improve Compliance for Nonresident Aliens and Updating Requirements Could Reduce Their Compliance Burden* 13-14 (Apr. 2010). The GAO interviewed IRS officials responsible for conducting outreach efforts and representatives from groups that work with employers and nonresidents to assist them in fulfilling their tax obligations, such as paid tax return preparers, accounting and law firms, and university business officers.

<sup>6</sup> For example, in Canada, nonresidents are not generally required to file a tax return if the withholding (final) tax is withheld by the payor. Canada Revenue Agency, at <http://www.cra-arc.gc.ca/tx/nrdsnts/ndvds/nrs-eng.html#common> (last visited July 25, 2011). See also Volume 2 study, *Analyzing Pay-as-You-Earn Systems as a Path for Simplification of the U.S. Tax System*, *infra*.

- Foreign individuals visiting the U.S. for short-term business trips may be unaware that they have a filing requirement, because comparable requirements may not exist in their own countries;
- Some tax return preparers are unfamiliar with nonresident alien tax rules;
- Foreign individuals cannot file Form 1040NR, *U.S. Nonresident Alien Income Tax Return*, electronically; and
- Foreign individuals have difficulty obtaining Individual Taxpayer Identification Numbers (ITINs) because of the volume and complexity of the documentation needed and because they cannot apply for ITINs electronically, even through IRS-sanctioned acceptance agents.<sup>7</sup>

## ANALYSIS OF PROBLEM

### Background

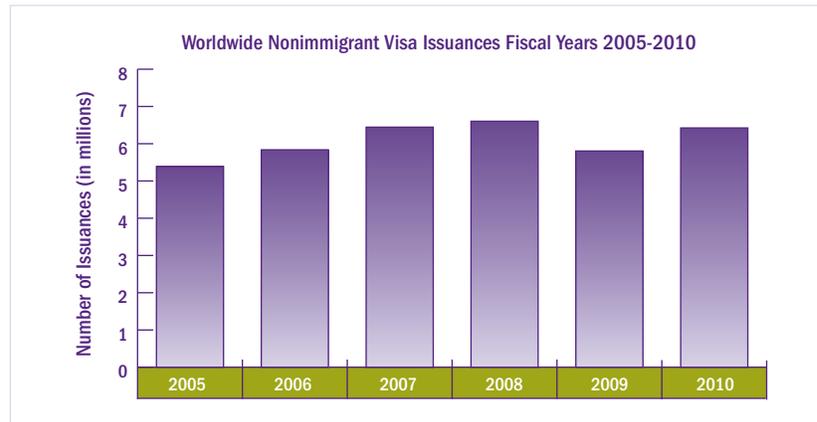
Taxpayers with U.S. filing obligations may reside in 194 countries and more than 60 territories, colonies, and dependencies of these countries.<sup>8</sup> In fiscal year (FY) 2010 alone, more than 6.4 million foreign individuals received nonimmigrant U.S. visas.<sup>9</sup> From FY 2005 to FY 2010, the U.S. Department of State issued between 5.3 and 6.6 million nonimmigrant visas annually as described in Figure 1.7.1 below.<sup>10</sup>

<sup>7</sup> Because the IRS requires the ITIN application to be filed on paper with a tax return, these taxpayers cannot file their returns electronically. The National Taxpayer Advocate has voiced concerns about the IRS's ITIN policy for many years. See National Taxpayer Advocate 2010 Annual Report to Congress 319-334; Taxpayer Advocate Directive 2009-1 (Feb. 25, 2009); National Taxpayer Advocate 2009 Annual Report to Congress 520-522; National Taxpayer Advocate 2008 Annual Report to Congress 126-140; National Taxpayer Advocate 2004 Annual Report to Congress 143-162; National Taxpayer Advocate 2003 Annual Report to Congress 60-86.

<sup>8</sup> See U.S. Department of State Fact Sheet, *Independent Countries of the World*, available at <http://www.state.gov/s/inr/rls/4250.htm> (last visited Oct. 14, 2011).

<sup>9</sup> U.S. Dept. of State, *Immigrant and Nonimmigrant Visas Issued at Foreign Service Posts FYs 2006- 2010*, available at [www.travel.state.gov](http://www.travel.state.gov) (last visited July 28, 2011).

<sup>10</sup> U.S. Dept. of State, *Worldwide Nonimmigrant Visas Issued at Foreign Service Posts FYs 2005- 2010*, Multi-Year Graphs, available at [http://www.travel.state.gov/visa/statistics/graphs/graphs\\_4399.html](http://www.travel.state.gov/visa/statistics/graphs/graphs_4399.html) (last visited July 28, 2011).

**FIGURE 1.7.1, U.S. Department of State, Worldwide Nonimmigrant Visa Issuances, FY 2005-FY 2010**

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,<sup>11</sup> it receives hundreds of thousands of returns from these taxpayers each year.<sup>12</sup> In tax year (TY) 2009, the IRS processed 702,607 returns from foreign individuals<sup>13</sup> and 33,043 returns of foreign corporations with U.S.-source income.<sup>14</sup>

#### The IRS Is Missing Opportunities to Educate Foreign Taxpayers.

The IRS has offices in only four countries, and even at these locations, the IRS tax attachés' main responsibilities focus on partner relationships, exchange of information agreements with foreign governments, and support of IRS investigations and examinations, with taxpayer service being an "important sideline."<sup>15</sup> The IRS attempts to reach out to this taxpayer population through Nationwide Tax Forums and other presentations, but it conducts most, if not all of these events, in the United States.<sup>16</sup> The target population by definition, however, resides outside the United States.

Because in-person taxpayer assistance is available at only four tax attaché posts abroad and is limited, the IRS cannot adequately educate foreign taxpayers and their foreign-based tax

<sup>11</sup> Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2009-IE-R001, *A Combination of Legislative Actions and Increased IRS Capability and Capacity Are Required to Reduce the Multi-Billion Dollar U.S. International Tax Gap 2* (Jan. 27, 2009).

<sup>12</sup> IRS Office of Research, Forecasting and Statistics, Document 6187 (Sept. 2010), Tables 1B.

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

<sup>14</sup> IRS Document 6292 (Sept. 2010), at 6. In TY 2006, there were 14,897 foreign corporations with effectively connected U.S. income and 63,951 domestic corporations controlled by foreign persons. IRS, *International Tax Overview, Statistics of Income Bulletin* (Summer 2010), available at <http://www.irs.gov/pub/irs-soi/10intertax.pdf>.

<sup>15</sup> The IRS posts are located in Frankfurt, London, Paris, and Beijing. See IRM 4.30.3.1 (Oct. 1, 2010); IRM 4.30.3.3 (Oct. 1, 2010). See also IRS Today Vol. 4 No.1 (Jan./Feb. 2008), *A Day in the Life of the Paris Tax Attaché*, [http://wsep.ds.irsnet.gov/sites/co/candl/CLDocs/IC/irstoday/IRSToday\\_JanFeb\\_v10.pdf](http://wsep.ds.irsnet.gov/sites/co/candl/CLDocs/IC/irstoday/IRSToday_JanFeb_v10.pdf) (last visited Dec. 23, 2011).

<sup>16</sup> The IRS presented annually to groups such as the American Payroll Association, the National Association of College and University Business Officers, the American Bar Association, Tax Executives Institute, and local attorney and certified public accountant groups in the United States. GAO, GAO-10-429, *IRS May Be Able to Improve Compliance for Nonresident Aliens and Updating Requirements Could Reduce Their Compliance Burden 12* (Apr. 2010).

advisors.<sup>17</sup> The IRS does not provide toll-free telephone assistance to taxpayers abroad.<sup>18</sup> It does not provide assistance in foreign languages (besides Spanish) even on a toll line; nor does it use web-based technologies to hold virtual face-to-face discussions with taxpayers.<sup>19</sup> IRS taxpayer service to nonresident alien taxpayers and foreign entities is limited to scarce English-language resources on the IRS.gov website. As a result, many of these taxpayers must hire a tax professional to fulfill their U.S. tax filing obligations. In contrast, the revenue agencies of several other countries provide full multilingual assistance and translate their entire websites and many tax assistance materials into various languages.<sup>20</sup>

### Foreign Taxpayers Need Multilingual Taxpayer Service and Outreach Materials.

Most IRS publications and website materials are not available in foreign languages, which means even web-based outreach to these taxpayers is problematic. The IRS should make relevant web resources, forms, and publications, including Publication 519, *U.S. Tax Guide for Aliens*, available in major foreign languages.

As a part of the federal government's effort to expand and integrate products and services for Limited English Proficient taxpayers, the IRS established the Multilingual Initiative program, later reorganized as the Language Services Branch (LSB).<sup>21</sup> In August 2010, LSB established the Asian Cadre, a group of bilingual employees to improve products and services in Chinese, Korean, Vietnamese, and Russian.<sup>22</sup> This innovative and cost-savvy approach has substantially improved products and publications in these languages.<sup>23</sup> The IRS can and should do more to translate forms, instructions, and publications into foreign languages, especially for nonresident taxpayers with U.S. filing obligations. The IRS also needs to place links to foreign language information prominently on the IRS.gov home-page, next to the Español link, to help foreign taxpayers with limited English proficiency.

<sup>17</sup> See Most Serious Problem: *Individual U.S. Taxpayers Working, Living, or Doing Business Abroad Require Expanded Service Targeting Their Specific Needs and Preferences*, *infra*.

<sup>18</sup> See National Taxpayer Advocate 2008 Annual Report to Congress 141-157.

<sup>19</sup> Since at least 2008, TAS proposed development and implementation of a pilot of two-way videoconferencing environment to provide a face-to-face experience for customers who live in remote areas, who have mobility issues or who are otherwise unable to travel to an office where there is a TAS presence. For a more detailed discussion of the Virtual Service Delivery (VSD), see Most Serious Problem: *Individual U.S. Taxpayers Working, Living, or Doing Business Abroad Require Expanded Service Targeting Their Specific Needs and Preferences*, *infra*. See also National Taxpayer Advocate 2010 Annual Report to Congress 267-277 (Most Serious Problem: *The IRS Has Been Reluctant to Implement Alternative Service Methods that Would Improve Accessibility for Taxpayers Who Seek Face-to-Face Assistance*); National Taxpayer Advocate 2008 Annual Report to Congress 95-113 (Most Serious Problem: *Taxpayer Service: Bringing Service to the Taxpayer*).

<sup>20</sup> For example, the Canada Revenue Agency's website is viewable in English and French (<http://www.cra-arc.gc.ca/menu-e.html>), the Mexican Tax Administration website in Spanish and English (<http://www.sat.gob.mx>), the Netherlands Tax Agency in Dutch, English, and German (<http://www.belastingdienst.nl/>), and the Chinese State Administration of Taxation website in Chinese and English (<http://www.chinatax.gov.cn/n480462/index.html>). The Australian Taxation Office has its website translated into 20 languages other than English. See <http://www.ato.gov.au/content/00171454.htm> (last visited Oct. 14, 2011).

<sup>21</sup> See Executive Order 13166, *Improving Services for Persons with Limited English Proficiency* (LEP), 65 FR 50121 (2000). See also Policy Statement P-22-3, IRM 22.31.1.1.2 (Apr. 1, 2006).

<sup>22</sup> IRS, Language Services Program, <http://mli.web.irs.gov/v3/home/index.asp> (last visited July 31, 2011).

<sup>23</sup> IRS publications translated into foreign languages by bilingual IRS employees contain the necessary foreign language tax terms and are adjusted to cultural and language differences of native speakers of those languages. In addition, the outsourced translation cost of one word ranges between 48 and 74 cents, while bilingual IRS employees conducted translations and reviews during their normal work hours without additional funding. Asian Cadre Training Conference, Washington, DC (July 19-22, 2011). See also email from IRS, Linguistic Policy, Tools and Services Section (Nov. 7, 2011).

The IRS needs focused outreach and separate publications in foreign languages for special groups of nonresident alien taxpayers, including:

- Foreign students and scholars;<sup>24</sup>
- Foreign professors and researchers;
- Visitors (business and pleasure);
- Foreign agricultural workers;
- Foreign athletes, artists, and entertainers;
- Foreign businessmen and investors, including real estate investors; and
- Foreign workers in U.S. territories, such as Guam, American Samoa, U.S. Virgin Islands, and the Commonwealth of Northern Mariana Islands.

The IRS should work with the departments of State and Homeland Security to distribute concise and plain-language publications for these groups at U.S. consulates and embassies that issue specific types of visas, and at U.S. ports of entry. It can also use U.S. embassy and consulate locations for virtual service delivery to provide assistance to these taxpayers.<sup>25</sup>

#### **The IRS Should Develop Electronic Filing and Payment Options for Nonresident Alien Taxpayers.**

Electronic filing is not available for the IRS Forms 1040NR, *U.S. Nonresident Alien Income Tax Return*, or 1040NR-EZ, *U.S. Income Tax Return for Certain Nonresident Aliens with No Dependents*. Foreign taxpayers also cannot use the Electronic Federal Tax Payment System to pay federal taxes via the Internet or phone, unless they have a bank account at a U.S. banking institution.<sup>26</sup> In addition, current IRS ITIN policy precludes first-time ITIN applicants from filing electronic returns, and causes backlogs of hundreds of thousands of unworked and suspended applications, a practice the National Taxpayer Advocate has opposed for years and about which she has advocated for and proposed alternatives.<sup>27</sup>

The IRS should redesign its systems to allow free electronic filing of foreign taxpayers' returns and concurrent payment of tax liabilities through a foreign-issued credit card and a wire transfer from a foreign bank. Because the IRS requires first-time nonresident alien filers to provide a taxpayer identifying number (TIN) to file a tax return, it should develop a system for free electronic filing of the Form W-7, *Application for IRS Individual Taxpayer*

<sup>24</sup> See, e.g., Systemic Advocacy Management System (SAMS) Issue 21534 (July 26, 2011) (discussing the inability of foreign students at the University of Kansas at Lawrence to file returns electronically and multiple ITIN rejections under the scholarship exception).

<sup>25</sup> VSD presentation materials, *Delivering Taxpayer Services Using Video Communications Technology*, IRS Senior Executive Team meeting (Sept. 6, 2011). For a detailed discussion of VSD, see Most Serious Problem: *Individual U.S. Taxpayers Working, Living, or Doing Business Abroad Require Expanded Service Targeting Their Specific Needs and Preferences*, *infra*.

<sup>26</sup> See Electronic Federal Tax Payment System, [www.eftps.gov](http://www.eftps.gov) (last visited Oct. 15, 2011).

<sup>27</sup> See National Taxpayer Advocate 2010 Annual Report to Congress 319-334; Taxpayer Advocate Directive 2009-1 (Feb. 25, 2009); National Taxpayer Advocate 2009 Annual Report to Congress 520-522; National Taxpayer Advocate 2008 Annual Report to Congress 126-140; National Taxpayer Advocate 2004 Annual Report to Congress 143-162; National Taxpayer Advocate 2003 Annual Report to Congress 60-86.

*Identification Number*, with functionality to allow electronic submission of required documentation proving that the nonresident alien has U.S.-source income.

## CONCLUSION

Foreign taxpayers with U.S. tax obligations are less equipped than domestic taxpayers to deal with the complexity of U.S. tax law and reporting obligations because they have limited or no English proficiency and because U.S. tax law and filing requirements may be very different from those of their home countries. The IRS often does not address taxpayer needs by market segment and instead is organized around administration of particular provisions.<sup>28</sup> However, the IRS's mission as a tax administrator for all taxpayers requires it to meet these taxpayers' needs.

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

1. Make relevant web resources, forms, and publications, including Publication 519, *U.S. Tax Guide for Aliens*, available in major foreign languages.
2. Place links to information in foreign languages prominently on the IRS.gov homepage next to the Español link.
3. Develop focused outreach and separate publications in foreign languages for special groups of nonresident alien taxpayers and foreign entities.
4. Partner with the Departments of State and Homeland Security to distribute concise publications for these specific groups at U.S. consulates and embassies in conjunction with issuance of a specific type of visa and at U.S. ports of entry.
5. Partner with the Department of State for virtual service delivery at U.S. embassies and consulates abroad.
6. Allow electronic filing of 1040NR series tax returns and ITIN applications for nonresident alien taxpayers, at least to those not claiming a refund.

## IRS COMMENTS

The IRS recognizes the issues faced by foreign taxpayers in fulfilling their U.S. tax obligations and we continue to look for opportunities to improve service delivered to this taxpayer base.

As previously discussed, last year, the IRS reorganized the office of the Deputy Commissioner, International (LB&I) to align international technical professionals within a single office to better identify, address, and resolve significant compliance issues faced by both individuals and businesses operating across borders. This realignment was driven in

<sup>28</sup> Many prior Annual Reports to Congress suggested or offered a basis for administrative and legislative recommendations to help address the needs of diverse taxpayer populations. For a detailed discussion, see *Introduction to Diversity Issues: The IRS Should Do More to Accommodate Changing Taxpayer Demographics*, *infra*.

large part by recognition of the complexity of the tax law applicable to taxpayers engaged in international activities and investments and the commensurate challenges to the IRS in communicating and enforcing those legal complexities. The Deputy Commissioner, International is responsible for coordinating IRS efforts in this area across all IRS Business Operating Divisions to ensure that the IRS's international strategy is aligned, balanced, and coordinated.

Improving taxpayer services to foreign taxpayers in fulfilling their U.S. tax obligations is an important strategic goal for the office of the Deputy Commissioner, International and the IRS in general. As part of FY 2012 priorities, the International Executive team is committed to coordinate closely with Wage & Investment and the Director, e-Services to perform a thorough review of specific problems faced by foreign taxpayers, identify modern options available to improve service, and make recommendations for implementing effective improvements. We will consider the views included in the National Taxpayer Advocate's report in this effort.

#### Service-wide Initiatives

Media & Publications (M&P), part of the IRS's Wage & Investment's CARE organization, provides IRS-wide support for publishing and distribution services, including outreach and education products for all international taxpayers. M&P is participating in an agency-wide group that is working to improve services to international taxpayers. In brief, M&P:

- Authors and publishes tax products for U.S. and international taxpayers. These products are available to all taxpayers, regardless of where they live and work, through "Forms and Publications" on IRS.gov.
- Administers a small bulk forms distribution program for embassies and military bases.
- Provides mail order fulfillment services to national and international requesters.

In addition, M&P has identified some actions for FY 12 that will improve services for international taxpayers. These include:

- Expanding our products and services to meet the needs of Limited English Proficient (LEP) taxpayers.
- Focusing on delivering electronic publishing and providing electronic options for disseminating products in formats customer prefer.
- Creating user friendly URLs (product pages) that include the content that clearly and succinctly describes the product's summary of purpose and links to helpful html and pdf files.

### Taxpayer Services

The IRS has several taxpayer service programs designed to foster compliance by foreign taxpayers. These include services abroad as well as services in the United States and are designed to provide taxpayer services to foreign taxpayers as well as any taxpayer with limited English proficiency.

***In-person taxpayer services*** at four foreign posts led by Tax Attachés: Taxpayer assistance is provided in London, Paris, Frankfurt, and Beijing. In addition, outreach events are conducted by each Tax Attaché in his/her designated countries of jurisdiction to enhance taxpayer assistance and treaty partner relationships.

The Tax Attachés located in London, Paris, Frankfurt, and Beijing are responsible for a broad scope of liaison, service, and enforcement roles for countries within their area of responsibility. These duties range from providing taxpayer service involving U.S. citizens, non-resident aliens, and entities to maintaining treaty partner relationships, complying with exchange of information per income tax treaties, supporting Chief Counsel and the Department of Treasury, and conducting outreach events with the Department of State, practitioner communities, business organizations, and other federal, state, and local agencies.

***Volunteer Income Tax Assistance:*** The IRS provides free tax assistance and return preparation in the United States at its Volunteer Income Tax Assistance (VITA) sites. All instructors have to certify on Link & Learn Taxes.<sup>29</sup> In addition, the IRS provides the VITA sites with software, training materials, and support via email throughout the tax season.

***Link & Learn Taxes:*** The IRS's Link & Learn Taxes program offers a course entitled "Foreign Students and Scholars" that is directed at the over 500,000 international students and scholars who are at American colleges and universities to study, teach, and do research. Many of these individuals need assistance understanding their tax obligations. This course covers the completion of returns for international students and scholars, and is available online at IRS.gov.

This course is designed to teach tax preparers to:

- Distinguish between resident and nonresident aliens;
- Determine whether a nonresident alien is required to file;
- Determine the correct forms to file;
- Determine whether a tax treaty applies and determine which income is taxable and which is excludable; and

<sup>29</sup> Link & Learn Taxes, *linking volunteers to qualify e-learning solutions*, is the IRS web-based program providing nine courses: Basic, Intermediate, Advanced, Military, International, Puerto Rico, and Foreign Student, along with a refresher course for returning volunteers, and two optional specialty courses on Cancellation of Debt and Health Savings Accounts.

- Correctly complete Form 8843, *Statement for Exempt Individuals and Individuals with a Medical Condition*; Forms 1040NR, *U.S. Nonresident Alien Income Tax Return*; and 1040NR-EZ, *U.S. Tax Return for Certain Nonresident Aliens With No Dependents*.

**Limited English Proficiency Initiative:** The IRS, through its Volunteer Return Preparation Program (Volunteer Program), has established the LEP Initiative to assist Hispanic, Asian, and Russian speaking taxpayers file their taxes by increasing communication, education, and services to the LEP community. The LEP Initiative has the following four strategic goals:

1. Align the Volunteer Program's content delivery and resources with LEP Hispanic, Asian, and Russian taxpayers and partners needs;
2. Enhance relationships with existing community coalitions and establish new partnerships to support LEP programs;
3. Increase the effectiveness of communication with the LEP Hispanic, Asian, and Russian populations; and
4. Improve and expand education and awareness activities to influence behavior regarding voluntary tax compliance.

The Volunteer Program is working collaboratively with Multilingual Agency Services (MAS) to produce approximately 25 outreach forms in Spanish, Chinese, Korean, Russian and/or Vietnamese. Not all forms are available in all languages.

**Over the Phone Interpreter Service and Pilot:** In 2009, the IRS implemented the Over the Phone Interpreter (OPI) Service, which is available at Taxpayer Assistance Centers (TACs) throughout the United States. Currently, the IRS is piloting an OPI Service program for use at VITA/TCE sites nationwide. This program allows the IRS to serve LEP taxpayers by providing foreign language translation services to partners and volunteers at VITA/TCE sites. This pilot expands existing OPI services previously only available for use by IRS employees. The Volunteer Program is working collaboratively with MAS to deliver this program to participating VITA/TCE partners.

The service, offered at no cost to taxpayers or participating partners, allows our partners/volunteers to communicate with LEP taxpayers at their sites in over 170 foreign languages, thereby facilitating the return preparation process. For FY 2012, the IRS solicited interest in the pilot and received over 160 responses from partners. Although the pilot is limited to 50 participants due to funding, it will allow the IRS to evaluate the success of the pilot at the end of the filing season and make a determination whether to expand the offering of OPI services at VITA/TCE sites in the future.

### Educating Foreign Taxpayers

The goal of the IRS is to ensure that all taxpayers with an obligation to pay U.S. taxes have the education and assistance that they need. While most Nationwide Tax Forums and webcasts are originally conducted in the United States, copies of previous Forum sessions and webcasts may be available on [irs.gov](http://irs.gov) to anyone with access to the Internet.

As the report of the National Taxpayer Advocate correctly noted, millions of foreign persons enter the United States every year. Some arrive as visitors, some arrive as students, and some come to work. Many of these foreign persons have no U.S. tax filing obligations. At the same time, many foreigners never travel to the United States at all, yet they may earn significant amounts of U.S. source income. It should be noted that a withholding agent can play an important role in the compliance process by educating the taxpayer at the time payments are made to the foreign taxpayer.

The Link & Learn program is available to anyone with access to the Internet. As noted earlier, in addition to the courses on the general federal income tax rules, this program has a course devoted entirely to the foreign student. It includes information that relates to any type of foreign taxpayer, however (for example, the resident/nonresident section).

### Foreign Language

The IRS has taken several steps to increase the availability of taxpayer services to taxpayers with limited English proficiency. IRM 22.31.1, *The Multilingual Initiative*, was finalized in 2006.

As discussed earlier, OPI service is available at TACs throughout the United States. By calling the toll-free number, any nonresident alien in the United States has access to IRS assistance in their language of choice through the use of an over-the-phone interpreter. This service is available in over 170 languages and is available 24 hours a day, seven days a week.

In addition, the IRS has two special websites available to taxpayers with limited English proficiency. The first, [www.irs.gov/espanol](http://www.irs.gov/espanol), includes access to many forms and publications in Spanish, including Publication 17, *El Impuesto Federal sobre los Ingresos* (Your Federal Income Tax). The second, [www.irs.gov/languages](http://www.irs.gov/languages), has information in Chinese, Korean, Vietnamese, and Russian. The IRS provides a DVD on basic tax responsibilities in five languages – Spanish, Chinese, Russian, Vietnamese, and Korean. This DVD is available at no charge to anyone.

In June 2010, the [irs.gov](http://irs.gov) website added a tab for “Other Languages” next to the Español link. The IRS has a page specifically designed for foreign students and scholars in the United States, with a substantial amount of information (in English) for the student.<sup>30</sup>

<sup>30</sup> See <http://www.irs.gov/businesses/small/international/article/0,,id=96431,00.html>.

### **Partner with the Departments of State and Homeland Security**

The IRS agrees that maximizing the availability of taxpayer assistance enhances compliance with the U.S. tax laws. The IRS continues to explore how to expand the range of taxpayer services offered outside the United States.

The IRS will consider whether it is possible to work more directly with the Department of State or the Department of Homeland Security to distribute tax information to taxpayers obtaining specific visas. The IRS currently distributes its Publication 4732, *Federal Tax Information for U.S. Taxpayers Living Abroad*, to all of the U.S. consulates and U.S. embassies. Publication 4732 provides helpful information to all foreign taxpayers (which include resident and nonresident aliens), individuals and businesses, with U.S. tax reporting requirements, such as tax tips, common publications for international taxpayers, contact information for embassies and consulates with on-site IRS assistance, and helpful IRS Internet links and phone numbers. We will take into account the views of the National Taxpayer Advocate as we evaluate this possibility.

The IRS also recently published an informational fact sheet illustrating how present law works for dual citizens.<sup>31</sup> This information was distributed to various embassy staffs for dissemination.

The National Taxpayer Advocate also recommended that Virtual Service Delivery (VSD) be offered at embassies and consulates. The VSD is currently being piloted at several locations to test taxpayer acceptance of the technology. VSD will use high resolution monitors with a high definition camera, integrated as one unit. Based on the outcome of the pilot, the IRS will consider whether it can implement VSD services at the embassies and consulates.

### **Electronic Filing of Form 1040NR series and ITIN applications**

As electronic filing implementation continues, Form 1040NR will be added to the list of forms that can be electronically filed. The National Taxpayer Advocate has discussed the issue of electronically applying for an ITIN in previous reports. The ITIN Unit has raised a number of issues that argue against permitting electronic filing of ITIN applications. At the present time, these conclusions have not changed.

### **Electronic Payment of Taxes**

While a foreign taxpayer cannot use the Electronic Federal Tax Payment System to pay federal taxes in exactly the same way as U.S. taxpayers can use the system, the IRS has several provisions that allow foreign taxpayers the option of paying their taxes electronically, even if the taxpayers do not have a bank account at a U.S. banking institution. They can use the Electronic Federal Tax Payment System by completing the same-day payment worksheet using the tax type code for the payment. Although the financial institution must have a relationship with a U.S.-based financial institution, it does not have to be an affiliate.

<sup>31</sup> See <http://www.irs.gov/newsroom/article/0,,id=250788,00.html>.

In addition, if the taxpayer does not have a U.S. bank account or if the taxpayer's foreign financial institution does not have a relationship with a U.S. based financial institution, a cash management account can be used (without a fee) to make the payment through the EFTPS system, which utilizes RTN/ABA. In addition, they can use a credit card and pay on-line or by telephone. These options are discussed at [www.irs.gov/e-pay](http://www.irs.gov/e-pay), and in Publication 966, *Electronic Choices to Pay All Your Federal Taxes* (also available in Spanish).

### Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS recognizes the issues faced by foreign taxpayers in fulfilling their U.S. tax obligations and agrees to consider her recommendations to improve service for these taxpayers. The National Taxpayer Advocate also commends the IRS for developing course materials about foreign students and scholars as a part of the Link & Learn Taxes program, although these courses are designed for VITA and TCE volunteers and not foreign taxpayers.<sup>32</sup> TAS supports the Limited English Proficiency program and the Multilingual Agency Services, which produced many outreach materials, forms, and publications in Spanish, Chinese, Korean, Russian, and Vietnamese.<sup>33</sup> We are also impressed with Over the Phone Interpreter service and pilot, and recommend that the IRS extend the service to all IRS phone assistants, including W&I Accounts Management function.<sup>34</sup>

The National Taxpayer Advocate is pleased with the IRS's willingness to explore opportunities to work more directly with the Departments of State and Homeland Security to distribute tax information to taxpayers obtaining visas. We applaud the virtual service pilot and urge delivery of this service at embassies and consulates.

The National Taxpayer Advocate is further encouraged that the IRS will add Form 1040NR to the list of forms that taxpayers can file electronically. However, and in the absence of a valid rationale, the IRS's continued refusal to consider electronic filing for any ITIN applications, including those with U.S.-source income, needlessly burdens applicants. These taxpayers must file paper applications and paper tax returns, and do not receive ITINs timely. Requiring paper ITIN applications to be attached to paper returns is also a labor intensive and inefficient use of IRS resources.

The National Taxpayer Advocate is concerned that the IRS does not address the recommendation to make relevant web resources and written materials available in major foreign

<sup>32</sup> In addition, we disagree with the IRS that the VITA program has the capacity to address the needs of 500,000 foreign students and scholars, since VITA clients are overwhelmingly domestic low income taxpayers targeted for Earned Income Tax Credit outreach.

<sup>33</sup> For example, bilingual TAS employees volunteered to review many MAS products in foreign languages. The IRS should expand LEP.

<sup>34</sup> TAS participation in the OPI service program began March 31, 2008 with the initial start-up of a 12-month pilot of the service. The OPI service is available for all TAS employees.

languages to foreign taxpayers. Although the IRS provides some domestic interpreter services and some information on basic tax responsibilities in some foreign languages, these services not address the needs of *foreign* taxpayers to have comprehensive references in major languages. Most programs cited in the IRS comments are not available for alien taxpayers residing abroad.<sup>35</sup> Even though the IRS website contains a link to “Other Languages” next to the “Español” link, it does not put links in foreign languages or symbols, which means an LEP taxpayer cannot recognize where to seek information in his or her language.

The IRS should make more outreach materials available in foreign languages and translate Publication 519, *U.S. Tax Guide for Aliens*, into at least five major languages supported by Multilingual Agency Services. The National Taxpayer Advocate encourages the IRS to extend the OPI pilot to the International Accounts Management function. The IRS should also develop outreach and educational materials for distinct groups of foreign taxpayers described above (*e.g.*, professors and researchers); visitors (business and pleasure); foreign agricultural workers; foreign athletes, artists, and entertainers; foreign businesspeople and investors, etc., similar to materials created for foreign students as a part of the Link & Learn initiative.

The procedures and links described in the IRS comments confirm that foreign taxpayers cannot make electronic payments online or by phone from abroad using a foreign bank account. The web link to Electronic Funds Withdrawal (EFW) and Debit and Credit Card Payment (DCCP) Options for Individuals does not contain a Form 1040NR or 1040NR-EZ in the list of forms eligible for EFW or DCCP.<sup>36</sup> In addition, to complete an EFTPS or EFW payment, a foreign taxpayer must have an account with a financial institution that has the American Bankers Association Routing Transit Number, which foreign financial institutions are ineligible to obtain.<sup>37</sup> Taxpayers choosing to pay by credit card must pay a fee ranging from 1.90 to 3.93 percent of the payment amount. It is the IRS’s responsibility as a tax administrator to provide free, seamless options for foreign taxpayers to fulfill their U.S. tax obligations.

<sup>35</sup> For example, all VITA sites are located in the U.S. IRS, *Nationwide Free Tax Preparation Site List*, available at <http://www.irs.gov/individuals/article/0,,id=219171,00.html> (last visited Dec. 14, 2011).

<sup>36</sup> IRS, *Electronic Funds Withdrawal and Credit or Debit Card Payment Options for Individuals*, <http://www.irs.gov/efile/article/0,,id=119097,00.html> (last visited Dec. 14, 2011).

<sup>37</sup> IRS, *Pay Taxes by Electronic Funds Withdrawal*, <http://www.irs.gov/efile/article/0,,id=101317,00.html> (last visited Dec. 14, 2011). An ABA Routing Number will only be issued to a federal or state chartered financial institution that is eligible to maintain an account at a Federal Reserve Bank. See American Bankers Association, *ABA Routing Number*, [http://www.aba.com/products/ps98\\_routing.htm](http://www.aba.com/products/ps98_routing.htm) (last visited on Dec. 14, 2011).

## Recommendations

In conclusion, the National Taxpayer Advocate offers these recommendations:

1. Make relevant web resources, forms, and publications, including Publication 519, *U.S. Tax Guide for Aliens*, available in major foreign languages.
2. Develop focused outreach and separate publications in foreign languages for special groups of nonresident alien taxpayers and foreign entities.
3. Partner with the Departments of State and Homeland Security to distribute concise publications for these specific groups at U.S. consulates and embassies in conjunction with issuance of a specific type of visa and at U.S. ports of entry.
4. Partner with the Department of State for virtual service delivery at U.S. embassies and consulates abroad.
5. Extend Over the Phone Interpreter service to all IRS phone assistants, including W&I Accounts Management function.
6. Allow electronic filing of 1040NR series tax returns and ITIN applications for nonresident alien taxpayers.

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

Richard E. Byrd Jr., Commissioner, Wage and Investment Division  
 Faris Fink, Commissioner, Small Business/Self-Employed Division  
 Heather C. Maloy, Commissioner, Large Business and International Division  
 Beth Tucker, Deputy Commissioner, Operations Support  
 Frank Keith, Chief, Communications and Liaison

**DEFINITION OF PROBLEM**

The complexity of international tax law combined with the procedural burden placed on individual U.S. taxpayers working, living, and doing business abroad creates an environment where taxpayers who are trying their best to comply simply cannot.<sup>1</sup> For some taxpayers, this means paying more U.S. tax than is legally required or incurring steep civil and criminal penalties. For others, the tax requirements are so confusing and the compliance burden is so great that they give up their U.S. citizenship.<sup>2</sup> The number of renunciations increased tenfold between fiscal years (FYs) 2008 and 2010.<sup>3</sup>

IRS Publication 4732, *Federal Tax Information for U.S. Taxpayers Living Abroad*, illustrates the complexity of the filing requirements. The publication refers to at least eight other relevant IRS publications, totaling 563 pages. The documents referred to in Publication 4732 add 4,727 pages of instructions, 667 pages of forms, and another 1,928 pages of form instructions, for a total of 7,322 pages.

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.”<sup>4</sup> Compared to all tax returns, international individual returns have two times the math error rate, and are less likely to be filed electronically or prepared using a paid preparer.<sup>5</sup> While the IRS has substantially stepped up and invested hundreds of millions of dollars

<sup>1</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*, *supra*.

<sup>2</sup> National Taxpayer Advocate meeting with the U.S. Ambassador to Switzerland (Feb. 4, 2011). See also Brian Knowlton, *More American Expatriates Give Up Citizenship*, N.Y. Times, Apr. 25, 2010; Helena Bachmann, *Why More U.S. Expatriates Are Turning in Their Passports*, Time World, Apr. 20, 2010.

<sup>3</sup> IRS, *Quarterly Publications of Individuals Who Have Chosen to Expatriate, as Required by Section 6039G, FY 2005 - FY 2011*, Federal Register, Vol. 70, No. 85, 217; Vol. 71, No. 25, 83, 166, 210, 228; Vol. 72, No. 22, 90, 151, 216; Vol. 73, No. 27, 90, 143, 212; Vol. 74, No. 23, 82, 138, 222; Vol. 75, No. 38, 99, 217; Vol. 76, No. 29, 90, 149.

<sup>4</sup> IRS, Wage & Investment Division (W&I) Research & Analysis, *Understanding the International Taxpayer Experience: Service Awareness, Use, Preferences, and Filing Behaviors*, Research Study Report (Feb. 2010).

<sup>5</sup> *Id.*

in international enforcement programs,<sup>6</sup> it has not adequately improved taxpayer service programs that would foster compliance among these taxpayers and target their specific needs and preferences.<sup>7</sup>

## ANALYSIS OF PROBLEM

### Background

The United States taxes the worldwide income of U.S. citizens, resident aliens, and domestic corporations.<sup>8</sup> An estimated five to seven million U.S. citizens reside abroad.<sup>9</sup> IRS data show that 858,760 taxpayers filed returns from a foreign address in calendar year (CY) 2009.<sup>10</sup>

Many U.S. taxpayers abroad are confused by the complex legal and reporting requirements and overwhelmed by the prospect of having to comply with them.<sup>11</sup> Some are even giving up their citizenship for that reason.<sup>12</sup> Overall, about 4,000 U.S. citizens renounced citizenship from fiscal year (FY) 2005 to FY 2010.<sup>13</sup> The number of renunciations increased more than tenfold from 146 in FY 2008 to 1,534 in FY 2010, with 1,024 renunciations during the first two quarters of FY 2011, as described on Figure 1.8.1 below.<sup>14</sup>

<sup>6</sup> The IRS requested and received roughly a quarter of a billion dollars for international enforcement in FYs 2010 and 2011. See IRS, *The Budget in Brief*, FY 2010 and FY 2011. See also Pub. L. No. 111-117 (Dec. 16, 2009); Pub. L. No. 112-10 (Apr. 15, 2011). See, e.g., Reuters, *Deutsche Bank U.S. Tax Fraud Deal Opens Floodgates* (Dec. 22, 2010) (reporting Deutsche Bank's \$553.6 million and UBS's \$780 million settlement with the IRS).

<sup>7</sup> See National Taxpayer Advocate 2009 Annual Report to Congress 134-154.

<sup>8</sup> See generally Internal Revenue Code (IRC) §§ 1(a), 11(a), 61(a), and 862(a)(5); Treas. Reg. § 1.1-1(b). See also IRC §§ 861, 862, 864, 871, 881, and 882.

<sup>9</sup> IRS, *Reaching Out to Americans Abroad* (Apr. 2009), <http://www.irs.gov/businesses/article/0,,id=205889,00.html>; W&I Research Study Report, *Understanding the International Taxpayer Experience: Service Awareness, Use, Preferences, and Filing Behaviors* (Feb. 2010) (citing U.S. Department of State data). This number does not include U.S. troops stationed abroad.

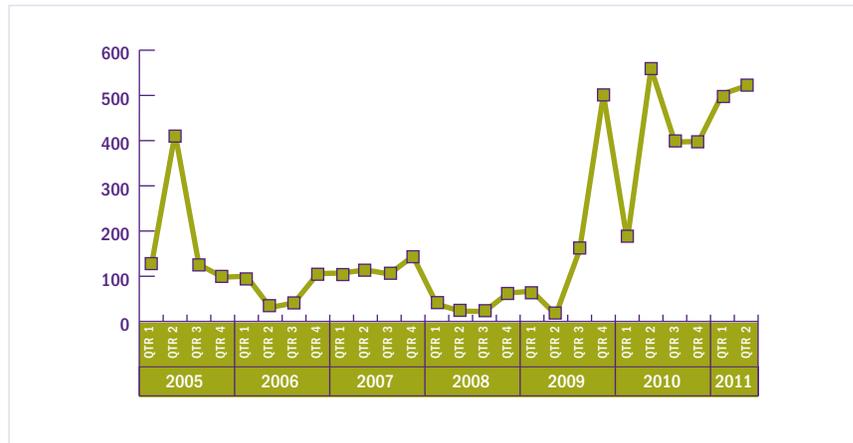
<sup>10</sup> IRS, Office of Research, Forecasting and Data Analysis, Document 6149 (Mar. 11, 2010), Table 53. Some taxpayers living overseas may have filed using a domestic (U.S.) address, have been listed as a spouse or a dependent on a primary taxpayer return, or not have had a filing obligation because their incomes fell below the filing threshold. The IRS has no way to identify any overseas residents from the tax return filings of taxpayers showing a U.S. address.

<sup>11</sup> W&I, Research & Analysis, *Understanding the International Taxpayer Experience: Service Awareness, Use, Preferences, and Filing Behaviors*, Research Study Report 24 (Feb. 2010) (Study Report). See also W&I, Research & Analysis, Focus Group Testing Report: *Customer Service Needs of U.S. Taxpayers Living Abroad*, Project # 3-08-07-S-017T (Dec. 2008) (Focus Group Report).

<sup>12</sup> National Taxpayer Advocate meeting with the U.S. Ambassador to Switzerland (Feb. 4, 2011). See also Brian Knowlton, *More American Expatriates Give Up Citizenship*, N.Y. Times, Apr. 25, 2010; Helena Bachmann, *Why More U.S. Expatriates Are Turning In Their Passports*, Time World, Apr. 20, 2010.

<sup>13</sup> IRS, *Quarterly Publications of Individuals Who Have Chosen To Expatriate, as Required by Section 6039G*, FY 2005 - FY 2011 (through second quarter), Federal Register, Vol. 70, No. 85, 217; Vol. 71, No. 25, 83, 166, 210, 228; Vol. 72, No. 22, 90, 151, 216; Vol. 73, No. 27, 90, 143, 212; Vol. 74, No. 23, 82, 138, 222; Vol. 75, No. 38, 99, 217; Vol. 76, No. 29, 90, 149.

<sup>14</sup> *Id.*

**FIGURE 1.8.1, Renunciations of U.S. Citizenship by Quarter, FY 2005 to FY 2011 (thru 2nd Quarter)**

### U.S. Taxpayers Abroad Experience Serious Service Challenges and a Higher Compliance Cost than Their Domestic Counterparts.

A recent IRS study found that U.S. taxpayers abroad are underserved, need expanded self-service channels, and may experience higher post-filing problems than the general taxpayer population.<sup>15</sup> The study grouped the service challenges into the following categories:

- Burden — Difficulty finding information;
- Availability of response — Difficulty reaching or receiving a response from the IRS; and
- Clarity — Difficulty understanding information.<sup>16</sup>

Examples of specific responses by survey respondents include:

- “The website is very difficult to use. You almost need to be a tax specialist to find anything. I spent more than an hour looking for the information I needed and finally gave up in frustration.”
- “No one has ever responded by email or letter.”
- “The information and forms are very confusing.”

Among the top taxpayer suggestions for additional products and services were:

- Information about specific tax issues (15 percent);
- The ability to prepare and file tax returns on the IRS website (seven percent);
- Simplified tax forms (five percent);
- Step-by-step/better/clearer instructions (four percent); and

<sup>15</sup> Study Report at 4.

<sup>16</sup> Study Report at 10-11. See also IRS, *W&I International Taxpayer Topline Report 5*, Pacific Consulting Group (Dec. 2009) (Survey Report).

- A toll-free phone line for international taxpayers (four percent).<sup>17</sup>

Study respondents and focus group participants also stated that finding a paid professional overseas to prepare U.S. tax returns is not only expensive, but difficult.<sup>18</sup>

IRS tax attachés estimate international tax preparation costs can exceed \$1,000 per return, while civic organizations of American citizens abroad set the figure as high as \$2,000 per return.<sup>19</sup> In contrast, the Treasury Inspector General for Tax Administration (TIGTA) estimates the average compliance costs for individuals in the United States range between \$173 and \$373.<sup>20</sup>

While the IRS has improved its IRS.gov website, the homepage does not prominently display the International Taxpayer link. IRS forms, instructions, and publications are lengthy and not designed to provide brief and concise information about specific international tax issues.<sup>21</sup> Further, survey and focus group participants say they need separate, specific information, publications and web pages for each of the nation's 60 tax treaties.<sup>22</sup>

Another challenge of dealing with the IRS for international taxpayers is the slow postal service in other countries, where one-way mail delivery can take up to three weeks.<sup>23</sup> These delays often compound IRS international mail delivery problems.<sup>24</sup>

### Free Electronic Filing of International Returns and Forms for All U.S. Taxpayers Abroad Would Reduce Compliance Burdens.

The National Taxpayer Advocate is pleased that the IRS now accepts electronically filed returns with foreign addresses.<sup>25</sup> Because the IRS does not provide direct electronic filing from its website, these taxpayers have to use one of the IRS Free File Alliance partners that support international taxpayer tax preparation and filing.<sup>26</sup> However, only five of the

<sup>17</sup> Study Report at 26.

<sup>18</sup> *Taxpayer Experience: Service Awareness, Use, Preferences, and Filing Behaviors, Research Study Report* (Feb. 2010); W&I, Research & Analysis, Focus Group Testing Report: *Customer Service Needs of U.S. Taxpayers Living Abroad*, Project # 3-08-07-S-017T (Dec. 2008).

<sup>19</sup> Cf. *Taxation of Americans Abroad*, position paper, Overseas Americans Week, Washington, DC (Apr. 11-15, 2011), at <http://www.overseasamericansweek.com/documents/2011/Taxes%20Sheet.pdf> (last visited July 30, 2011); and *Taxpayer Experience: Service Awareness, Use, Preferences, and Filing Behaviors, Research Study Report* (Feb. 2010); W&I, Research & Analysis, Focus Group Testing Report: *Customer Service Needs of U.S. Taxpayers Living Abroad*, Project # 3-08-07-S-017T (Dec. 2008).

<sup>20</sup> TIGTA, Ref. No. 2008-40-170, *Many Taxpayers Who Obtain Tax Refund Anticipation Loans May Benefit from Tax Preparation Services* (Aug. 29, 2008).

<sup>21</sup> Most taxpayers needed information about a specific tax issue. Study Report at 24. For example, one practitioner stated Form 2555, *Foreign Earned Income Exclusion*, "is not a simple form." Practitioners also expressed a need for a more understandable Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*. Form 1116, *Foreign Tax Credit*, was also mentioned as a form that should be revised and simplified. Focus Group Report at 9-11.

<sup>22</sup> See, e.g., the only country-specific tax treaty publication – IRS Publication 597, *Information on the United States-Canada Income Tax Treaty* (Aug. 2009).

<sup>23</sup> See also email from Executive Director, Association of American Citizens Abroad, to the National Taxpayer Advocate (May 13, 2011) (providing examples of compliance challenges facing U.S. taxpayers abroad).

<sup>24</sup> Mail to international locations is often undeliverable or significantly delayed. About 65 percent of all international mail is classified as "undeliverable as addressed." National Taxpayer Advocate 2010 Annual Report to Congress 221.

<sup>25</sup> See IRS, *U.S. Citizens and Resident Aliens Abroad*, at <http://www.irs.gov/businesses/small/international/article/0,,id=97324,00.html> (last visited Oct. 4, 2011).

<sup>26</sup> See IRS, *About the Free File Alliance*, at <http://www.irs.gov/efile/article/0,,id=200980,00.html> (last visited July 31, 2011).

17 Free File providers accept electronic returns from U.S. citizens and resident aliens with foreign addresses. The program is also limited to taxpayers with an Adjusted Gross Income (AGI) of \$57,000 or less in tax year (TY) 2011; those with an AGI exceeding \$57,000 have to purchase commercial software.<sup>27</sup>

IRS data for CY 2009 show that taxpayers with foreign addresses filed 858,760 Form 1040 series returns, but only 284,810 of them were filed electronically.<sup>28</sup> It is a longstanding position of the National Taxpayer Advocate that taxpayers should be able to file their returns electronically without a transaction fee.<sup>29</sup> A free template and direct filing portal would eliminate fees and increase the number of taxpayers filing their returns electronically, benefiting both taxpayers and the government. At the very least, the IRS should require all Free File Alliance partners to allow tax preparation and filing of all international forms for individuals with foreign addresses.

### **Simplification of Returns and Forms for Individual U.S. Taxpayers Abroad Can Substantially Decrease Burden and Avoid Waste of IRS Resources.**

The IRS has broad authority to prescribe the time and manner in which taxpayers file returns and the format of various required forms.<sup>30</sup> The annual income of many individual U.S. taxpayers abroad may be below the foreign earned income exclusion and foreign housing exclusion or deduction combined.<sup>31</sup> Taxpayers in many countries may have a higher effective income tax rate than in the U.S., and therefore the foreign tax credit (FTC) will result in zero or *de minimis* tax liability in the U.S.<sup>32</sup> For TY 2009, 5.5 million taxpayers (or 89 percent of the 6.2 million individuals claiming an FTC) had an FTC of \$300 or less.<sup>33</sup>

Figure 1.8.2 below shows that for TY 2009, 88 percent of all taxpayers claiming the foreign earned income exclusion (FEIE) did not have U.S. tax liability after applying the exclusion. After the application of the FTC, only about nine percent of these taxpayers had a U.S. tax liability.

<sup>27</sup> IRS, Freefile, at <http://www.freefile.irs.gov/how-e-file-works.html> (last visited Nov. 22, 2011).

<sup>28</sup> IRS Document 6109, Calendar Year Return Projections by State CYs 2010-2017, 2010 Update (Nov. 2010).

<sup>29</sup> See *Tax Return Preparation Options for Taxpayers*, Hearing Before the S. Comm. on Finance, 109th Cong. (Apr. 4, 2006) (statement of Nina E. Olson, National Taxpayer Advocate). See also National Taxpayer Advocate 2004 Annual Report to Congress 471-477 (Key Legislative Recommendation: *Free Electronic Filing for All Taxpayers*).

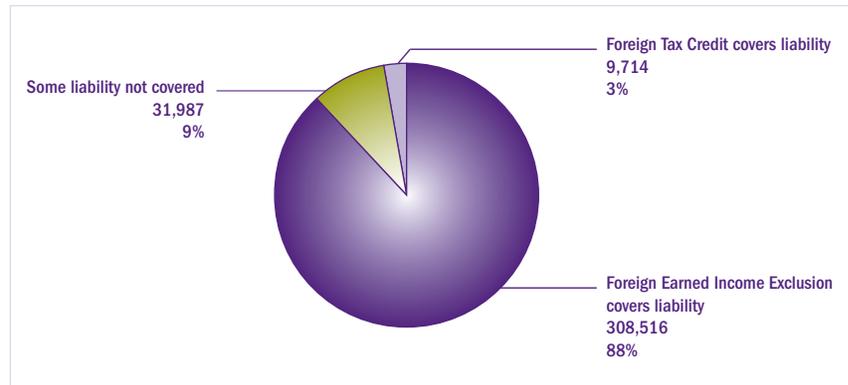
<sup>30</sup> See, e.g., IRC §§ 6001, 6011.

<sup>31</sup> IRC § 911(b)(2)(D), (c) and (d). In tax year (TY) 2010, the indexed-for-inflation foreign earned income exclusion was \$91,500.

<sup>32</sup> See generally IRC §§ 901 and 903.

<sup>33</sup> IRS, Compliance Data Warehouse (CDW), IRTF\_F1040 Table, Data Drawn Cycle 201140. Similar IRS analysis showed that nearly 2.7 million or 86 percent of individual taxpayers claiming a FTC had a credit of \$300 or less for TY 1999. IRS, Small Business/Self-Employed Division (SB/SE) Research – Philadelphia, Project # 05.02.001.03, International Taxpayer Research Project 7 (Aug. 2003).

**FIGURE 1.8.2, U.S. Taxpayers Abroad Who Did Not Have U.S. Tax Liability After Application of FEIE and FTC in TY 2009<sup>34</sup>**



In both situations, the IRS can and should significantly simplify tax return and information reporting forms and expand self-serve options, including TeleFile,<sup>35</sup> fax,<sup>36</sup> and a free web application from IRS.gov (“Netfile”).<sup>37</sup> This approach would substantially decrease burden on U.S. taxpayers abroad and free up IRS resources for examinations of other returns with substantial tax liabilities.<sup>38</sup>

### **The IRS Has Not Acted on Recommendations to Provide In-Person and Toll-Free Telephone Service in Countries Where the Most U.S. Taxpayers Live.**

While the IRS educates and assists domestic taxpayers through more than 400 Taxpayer Assistance Centers (TACs) around the country and serves practitioners at its Nationwide Tax Forums (in the U.S.), taxpayers abroad lack toll-free telephone service and in-person assistance in most countries.<sup>39</sup> As described earlier, the IRS invests millions of dollars in international enforcement, neglecting service needs of these taxpayers.<sup>40</sup> The IRS has not

<sup>34</sup> IRS, Compliance Data Warehouse (CDW), IRTF\_F1040 Table, Data Drawn Cycle 201140. Similar IRS analysis showed that nearly 2.7 million or 86 percent of individual taxpayers claiming a FTC had a credit of \$300 or less for TY 1999. IRS, Small Business/Self-Employed Division (SB/SE) Research – Philadelphia, Project # 05.02.001.03, International Taxpayer Research Project 7 (Aug. 2003).

<sup>35</sup> National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 121-155 (*TeleFile – Taxpayers’ Characteristics and Filing Behaviors: A Study to Enhance Taxpayer Assistance Blueprint Knowledge*).

<sup>36</sup> Focus group and survey participants suggested the IRS accept faxed signatures as opposed to only accepting original signatures for tax returns to help lower the costs and time associated with international mail.

<sup>37</sup> Financial Crimes Enforcement Network (FinCEN) recently has created a free and easy-to-use online Report of Foreign Bank and Financial Accounts (FBAR) filing system, FinCEN press-release (July 18, 2011). See BSA E-Filing System, *File an FBAR*, at [http://bsaeiling.fincen.treas.gov/Enroll\\_Individual.html](http://bsaeiling.fincen.treas.gov/Enroll_Individual.html) (last visited July 30, 2011).

<sup>38</sup> See email from Executive Director, Association of American Citizens Abroad, to the National Taxpayer Advocate (May 13, 2011) (providing examples of compliance challenges facing U.S. taxpayers abroad). See also SAMS Issue No. 22425 (Oct. 16, 2011).

<sup>39</sup> IRS, Contact My Local Office, at <http://www.irs.gov/localcontacts/index.html> (last visited Oct. 26, 2011). National Taxpayer Advocate 2009 Annual Report to Congress 134-154; National Taxpayer Advocate 2008 Annual Report to Congress 141-157. The IRS does maintain four overseas tax attaché posts, mostly devoted to examinations and the exchange of information with foreign governments; only a limited number of attaché employees are assigned to taxpayer service. In recent years, the IRS decreased the number of tax attaché posts in foreign cities from 15 to four, while increasing the number of locations and employees devoted to criminal investigations from eight to 18.

<sup>40</sup> See Most Serious Problem: *Globalization Requires Greater Internal IRS Coordination of International Taxpayer Service*, *infra*.

implemented the agreed-upon recommendations from the National Taxpayer Advocate's 2008 and 2009 Annual Reports to Congress to establish a toll-free line for U.S. taxpayers in Canada<sup>41</sup> and Mexico, and to open case resolution rooms at tax attaché posts and during tax events abroad.<sup>42</sup> The IRS also has not agreed to reopen the post in Mexico City, Mexico, in a country where about one million U.S. taxpayers reside.<sup>43</sup> Instead, it asked the National Taxpayer Advocate to cancel the recommendation to “devote more to taxpayer service, including reinstatement of in-person taxpayer service to U.S. taxpayers residing in Mexico” based on insufficient funding.<sup>44</sup>

In response to National Taxpayer Advocate recommendations in the 2009 Annual Report to Congress, the Large Business and International division (LB&I) conducted an attaché post expansion analysis to determine the locations in which increased IRS presence would have the largest impact on international tax compliance.<sup>45</sup> The quantitative analysis evaluated countries based on the following criteria:

- Large populations of U.S. citizens;
- Large or quickly growing number of U.S. companies;
- Strong trade partnership with the U.S.;
- Sizable gross domestic product;
- Sizable existing tax workload that supports a need for a foreign post; and
- Organization for Economic Co-operation and Development (OECD) member or a member of Leeds Castle Group.<sup>46</sup>

After analyzing these criteria for 111 countries, LB&I selected nine as candidates for post expansion:

- Seven treaty countries based on the highest increase of double taxation cases over the past five years (India, Japan, Poland, Israel, Philippines, South Africa, Australia); and
- Two no-tax treaty countries based on corporate growth rate and potential for tax treaties (Brazil and Chile).

<sup>41</sup> SAMS Issue 17493 (May 14, 2010). For example, Canadian taxpayers can call Canada Revenue Agency toll-free from anywhere in the continental U.S.

<sup>42</sup> National Taxpayer Advocate 2009 Annual Report to Congress 134-154; National Taxpayer Advocate 2008 Annual Report to Congress 141-157. See Department of Treasury, Joint Audit Management Enterprise System (JAMES) TAS--09-ARC-001MSP, 7-3-1; IRM 1.55.6.2 (Jan. 1, 2011).

<sup>43</sup> It is estimated that about 1,036,300 U.S. taxpayers reside in Mexico and 687,700 in Canada. National Taxpayer Advocate 2009 Annual Report to Congress 134-154.

<sup>44</sup> LB&I Request for Cancellation of Agreed to Action(s), TAS-09-ARC-001MSP, 7-3-1 (Apr. 15, 2011).

<sup>45</sup> National Taxpayer Advocate Annual Report to Congress recommendations are tracked on the JAMES system. JAMES, IRS Response to TAS recommendation, TAS--09-ARC-001MSP, 7-3-1.

<sup>46</sup> IRS Tax Attaché Posts Expansion Proposal, Executive Summary, *Increase the Number of Foreign Posts of Duty* (undated). Email from LB&I official to TAS (Oct. 11, 2011). In 2006, the tax authorities of ten countries formed the so-called “Leeds Castle Group,” which meets regularly to discuss issues of global and national tax administration, including mutual compliance challenges, tax shelters, and the challenges of increased globalization. The participating countries are Australia, Canada, China, France, Germany, India, Japan, South Korea, the U.K., and the U.S.

The study further suggested conducting additional analysis based on executive input and finalizing post-expansion recommendations. However, the study abruptly ended due to “budgetary and other considerations.” The National Taxpayer Advocate believes that the IRS should not underestimate the value of in-person service to voluntary compliance and should request funding for tax attaché post expansion, at least for countries where most U.S. taxpayers live.<sup>47</sup> The IRS should also allocate resources to TAS for creation of four Local Taxpayer Advocate (LTA) positions co-located with current IRS posts in London, Paris, Frankfurt, and Beijing as a part of the revised international taxpayer service strategy, and to fund additional LTA positions as additional attaché offices are opened.<sup>48</sup>

### **Use of Innovative and Cost-Effective Methods of Providing In-Person Service to U.S. Taxpayers Abroad Could Significantly Improve Compliance.**

The IRS should be proactive and innovative in finding cost-effective ways to serve U.S. taxpayers abroad, beginning by expanding electronic services to these taxpayers, including secure email, electronic access to IRS accounts, virtual face-to-face meetings, and encrypted email correspondence about account-specific international return inquiries.<sup>49</sup> For example, the Social Security Administration, which has no offices outside the U.S., has partnered with the Department of State to provide a full range of services, including accepting applications for benefits through specially trained embassy and consulate employees in 33 countries with a relatively large number of Social Security customers.<sup>50</sup> Among such cost-efficient initiatives might be:

- Partnering with the Department of State to train embassy and consulate staff to provide a full range of taxpayer services, including assistance with preparation of tax returns, similar to what the Social Security Administration does for beneficiaries overseas;
- Extending toll-free telephone service to taxpayers in Canada and Mexico where about 700,000 and over one million U.S. citizens live, respectively;<sup>51</sup>
- Conducting seminars and Tax Forums for international taxpayers through webcasts;

<sup>47</sup> National Taxpayer Advocate 2009 Annual Report to Congress 154.

<sup>48</sup> See Most Serious Problem: *Globalization Requires Greater Internal IRS Coordination of International Taxpayer Service, infra*. Local Taxpayer Advocates will be solely devoted to educating taxpayers abroad and resolving their compliance problems with the IRS. The actual cases would be worked by stateside TAS employees but the Local Taxpayer Advocate would be responsible for outreach, education, case intake and identification of systemic problems for relevant populations. The IRS can free up funding either by re-allocating funds from enforcement to taxpayer service or by moving some of the existing tax attaché positions to TAS.

<sup>49</sup> For example, Entrust, Inc., provides secure email and authentication solutions to many government agencies. See *generally* [www.entrust.com](http://www.entrust.com). The IRS uses Entrust encryption for internal communications. The IRS does currently provide international taxpayers with the Electronic Tax Law Assistance (ETLA) tool via [www.irs.gov/help/page/0,,id=133197,00.html](http://www.irs.gov/help/page/0,,id=133197,00.html) (last visited July 30, 2011). However, this tool cannot be used for account-specific inquiries. Focus group participants also complained about “not getting clear answers to their questions or not getting answers at all.” Focus Group Testing Report: *Customer Service Needs of U.S. Taxpayers Living Abroad 7*, Project # 3-08-07-S-017T (Dec. 2008).

<sup>50</sup> See U.S. Social Security Administration, Office of International Operations, *Service Around the World*, at <http://www.ssa.gov/foreign/index.html> (last visited July 28, 2011).

<sup>51</sup> See National Taxpayer Advocate 2009 Annual Report to Congress 143-154. Because Canada is allocated the same “country code + 1” as the United States, additional cost of extending existing 1-800 service for the continental U.S. to Canada would be minimal.

- Piloting secure email communications and access to the MyIRS account application for international taxpayers, including providing answers to account-specific questions; and
- Implementing Virtual Service Delivery (VSD) for international taxpayers.<sup>52</sup>

In FY 2010, TAS proposed a VSD operation to conduct virtual face-to-face meetings and conferences with taxpayers.<sup>53</sup> This proposal led to a TAS pilot to conduct videoconferencing from locations where TAS lacks geographic presence, including IRS and third-party locations, such as Low Income Taxpayer Clinics.<sup>54</sup> TAS also proposed to extend the VSD pilot to international taxpayers who would contact TAS from their home computers or secure third-party locations (*e.g.*, U.S. embassies and consulates or organizations of U.S. citizens abroad), and suggested a secure email pilot for international taxpayers. The IRS should not delay the implementation of these projects that would substantially improve service for the underserved taxpayers abroad.

## CONCLUSION

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

1. Simplify tax return and information reporting forms for individual U.S. taxpayers abroad.
2. Expand self-serve options, including TeleFile, fax, and Free File, and develop a free website application from IRS.gov (NetFile).
3. Extend telephone access to the existing Accounts Management function and the National Taxpayer Advocate (NTA) toll-free lines for the continental U.S. to taxpayers in Canada and Mexico.
4. Pilot secure email communications, virtual service delivery, and access to the MyIRS account application for international taxpayers, including answers to account-specific questions and access to TAS.
5. Establish a tax attaché office in Mexico.
6. Partner with the Department of State to train embassy and consulate staff to provide a full range of taxpayer services, including assistance with preparation of tax returns, similar to what the Social Security Administration does for beneficiaries overseas.

<sup>52</sup> VSD uses video communications technology to (1) provide a service delivery alternative outside of IRS facilities; (2) enhance utilization of IRS resources; (3) smooth staffing and workload imbalances; and (4) increase access to face-to-face service where currently unavailable. Virtual Service Delivery - Delivering Taxpayer Services Using Video Communications Technology, IRS Commissioner Briefing (Sept. 26, 2011).

<sup>53</sup> VSD presentation materials, Delivering Taxpayer Services Using Video Communications Technology, IRS Senior Executive Team meeting (Sept. 6, 2011).

<sup>54</sup> Prior to its inclusion in the IRS Virtual Service Delivery Pilot, TAS had proposed the development and implementation of a two-way videoconferencing environment to provide a face-to-face experience for customers who live in remote areas, have mobility issues or are otherwise unable to travel to an office where there is a TAS presence, or live in a high-density population area where TAS does not currently have an office.

## IRS COMMENTS

The IRS recognizes the issues faced by individual United States taxpayers working, living, or doing business abroad and we continue to look for opportunities to improve service delivered to this taxpayer base.

Last year, the IRS reorganized the office of the Deputy Commissioner, International (LB&I) to align international technical professionals within a single office to better identify, address, and resolve significant compliance issues faced by both individuals and businesses operating across borders. This realignment was driven in large part by recognition of the great high complexity of the tax law applicable to taxpayers engaged in international activities and investments and the commensurate challenges to the IRS in communicating and enforcing those legal complexities. The Deputy Commissioner, International is responsible for coordinating IRS efforts in this area across all IRS Business Operating Divisions to ensure that IRS' international strategy aligned, balanced, and coordinated.

Improving taxpayer services to U.S. taxpayers who work, live, and conduct business abroad is an important strategic goal for the office of the Deputy Commissioner, International and the IRS in general. As part of FY 2012 priorities, the International Executive team is committed to coordinate closely with Wage and Investment and the Director, e-Services to perform a thorough review of specific problems faced by overseas taxpayers, identify modern options available to improve service, and make recommendations for implementing effective improvements. We will consider the views included in the National Taxpayer Advocate's report in this effort.

### Current Overseas Taxpayer Service Programs

The IRS has several overseas taxpayer service programs designed to foster compliance and provide information to U.S. taxpayers living or doing business abroad:

**In-person taxpayer services at four foreign posts led by Tax Attachés:** Taxpayer assistance is provided in London, Paris, Frankfurt, and Beijing. In addition, outreach events are conducted by each Tax Attaché in his or her designated countries of jurisdiction to enhance taxpayer assistance and treaty partner relationships.

The Tax Attachés located in London, Paris, Frankfurt, and Beijing are responsible for a broad scope of liaison, service, and enforcement roles for countries within their area of responsibility. These duties range from providing taxpayer service involving U.S. citizens, non-resident aliens, and entities to maintaining treaty partner relationships, complying with exchange of information per income tax treaties, supporting Chief Counsel and Department of Treasury, and conducting outreach events with Department of State, practitioner communities, business organizations, and other federal, state, and local agencies.

**Free return preparation for U.S. military living overseas:** To assist all military personnel living overseas, the IRS provides free tax assistance and return preparation at its Volunteer Income Tax Assistance (VITA) sites. For FY 2011, the IRS had 66 VITA sites located overseas at U.S. military bases where volunteers prepared approximately 45,000 returns.

To ensure that the military personnel who work at overseas VITA sites are properly trained each year, IRS instructors travel overseas to teach at these sites. For FY 2011, ten IRS instructors held classes at 21 military bases in Europe, Asia, and Guam. One or two representatives from each of the overseas VITA locations attended an IRS-led class and then returned to his or her home location to train the rest of the preparers at their VITA site. All instructors have to certify on Link & Learn Taxes through the International level.<sup>55</sup> In addition, IRS provides these sites with software, training materials and support via e-mail throughout the tax season.

**Technology Applications available to taxpayers:** The IRS has implemented several technology enhancements that can assist taxpayers to obtain information more easily and we will continue to make additional improvements in this area. A new phone application, IRS2Go, can be downloaded to a smartphone for free. Taxpayers can use this app to do a number of things, including checking the status of their tax refund and subscribing to tax tips. In addition, the IRS posts videos on YouTube ([www.youtube.com/irsvideos](http://www.youtube.com/irsvideos)) to help taxpayers understand their tax obligations and has a news feed on Twitter (@IRSnews). Taxpayers also can access video clips of tax topics, archived versions of live panel discussions and Webinars, and audio archives of tax practitioner phone forums on the IRS Video portal ([www.IRSvideos.gov](http://www.IRSvideos.gov)). If taxpayers need to determine if there is a filing requirement for Form 6251, *Alternative Minimum Tax for Individuals*, an electronic “AMT Assistant” is available on IRS.gov. An electronic “Withholding Calculator” is also available on IRS.gov to help taxpayers determine if they need to file a new Form W-4, Employee’s Withholding Tax Certificate, or if they need to complete a new Form W-4 to change their withholding allowances. In addition, the IRS has developed user-friendly URLs on IRS.gov (e.g., [www.irs.gov/form.1040](http://www.irs.gov/form.1040)) where taxpayers can find current and prior forms/instructions and publications and related useful information.

**Piloting secure email communications:** The IRS understands the growing need to electronically communicate with both domestic and international taxpayers via email and must do this while providing for the security of taxpayer data and maintaining the public’s trust and confidence in that ability. To explore the use of the secure email functionality for exchange of information with our partners such as other federal agencies, state and local jurisdictions, government contractors, and banks, the IRS has established a limited pilot program for the exchange of taxpayer audit information with large scale organizations through the LB&I Division. This is a complex process that requires a significant amount of

<sup>55</sup> Link & Learn Taxes, *linking volunteers to quality e-learning solutions*, is the IRS web-based program providing nine courses: Basic, Intermediate, Advanced Military, International, Puerto Rico and Foreign Student, along with a refresher course for returning volunteers and two optional specialty courses on Cancellation of Debt and Health Savings Accounts.

effort and coordination between the IRS and the business taxpayer participants including resolving information technology compatibility issues. While the IRS is hopeful regarding the success of this pilot, it is important to recognize that there are considerable barriers to expanding this implementation to individual taxpayers, including authentication issues, computer security issues, and budgetary restraints on resources.

**Implementing Virtual Service Delivery (VSD):** VSD is being used by the IRS at multiple locations. As the service is expanded in more locations, we will consider whether it is possible to implement VSD abroad in United States Embassy and Consulate facilities.

### Significant Improvement

**IRS FBAR and Title 31 Helpline:** In July 2011 the IRS opened a new telephone help line for questions about foreign bank account reports. The IRS FBAR and Title 31 Helpline connects practitioners and filers, both in the U.S. and abroad, with a team of specially trained technicians, examiners and specialists to answer technical questions about Title 31, the Bank Secrecy Act. They answer questions related to reports required by the Bank Secrecy Act, such as the FBAR.

The Helpline is open Monday through Friday, 8:00 a.m. to 4:30 p.m., Eastern Time, and has a voice message feature for any calls received after hours. The Helpline has a toll-free number for calls from within the U.S. and a non-toll-free number for calls from outside of the U.S. Taxpayers and practitioners can also find answers on FBAR frequently asked questions page on IRS.gov or by sending an inquiry to [FBARquestions@irs.gov](mailto:FBARquestions@irs.gov).

In addition, in January 2011, the IRS established a Servicewide FBAR Communication Strategy Team to provide increased awareness and information to taxpayers. This servicewide collaboration helped to ensure taxpayers and practitioners received consistent, accurate and accessible information pertaining to FBAR filing requirements, the penalty structure, and the tangential Voluntary Disclosure Program.

The team employed traditional means of disseminating information by posting articles and updating Frequently Asked Questions on IRS.gov. Additionally, the team sought out new methods of reaching a wider audience, specifically filers residing abroad. Those methods included a June 1, 2011 FBAR Webinar, *Reporting Foreign Financial Accounts on the FBAR*, Twitter alerts, and a May 6, 2011 educational video, *When & How to Report Foreign Financial Accounts*. The Twitter alerts not only invited participation in the FBAR Webinar, but were also used to remind FBAR filers of the June 30 filing deadline.

### Mexico City Post

With respect to the recommendation to re-open the Mexico City post, we do not believe that the magnitude of the overseas service challenge can be adequately addressed by incurring the substantial costs of placing single individuals in overseas offices to answer the telephone or handle walk-in assistance requests.

The factors considered for opening a foreign post are many. In addition to taxpayer assistance, a primary factor is managing the treaty relationship as the Competent Authority is charged with properly administering the Income Tax Treaties and Tax Information Exchange Agreements that the United States has entered with foreign jurisdictions. We are able to effectively manage our treaty relationship responsibilities with Mexico (Exchange of Information and the Mutual Agreement Procedure) from the United States.

Furthermore, as with most foreign posts, the location of Mexico City will not afford every taxpayer an opportunity to avail themselves of taxpayer service as not all taxpayers resident in Mexico are able to travel to Mexico City. Especially given limited budgets, our efforts will be focused on delivery channels that leverage automated tools.

#### **Partnering with Department of State**

The IRS agrees that maximizing the availability of taxpayer assistance enhances compliance with the U.S. tax laws. The IRS continues to explore how to expand the range of taxpayer services offered outside the United States.

The Federal Benefits Units (FBU) is a partnership between the Social Security Administration (SSA) and the Veteran's Administration (VA). Those employees have access to the VA and SSA databases to resolve issues, initiate benefits, etc.

The IRS will consider whether it is possible to work more directly with the Department of State to provide taxpayer services through consul employees. While we will explore this recommendation, we do have concerns with existing workload as well as complications of having non-IRS personnel provide these services. We will take into account the views of the National Taxpayer Advocate as we evaluate this possibility.

### **Taxpayer Advocate Service Comments**

The National Taxpayer Advocate is pleased that the IRS recognizes that individual United States taxpayers working, living, or doing business abroad face special burdens in complying with their U.S. tax obligations, and that providing service to this taxpayer base is an important strategic goal.

However, the IRS comments confirm the lack of a coordinated service strategy for U.S. taxpayers working, living, and conducting business abroad. The IRS does not present a clear picture of how it plans to improve services for these taxpayers. The efforts cited, such as the web-based AMT Assistant and electronic withholding calculator, are generic. They do not offer specific programs addressing these taxpayers' needs and preferences as indicated

in at least three recent research, focus group, and survey reports.<sup>56</sup> It is also unclear how U.S. taxpayers working overseas for foreign employers could benefit from the withholding calculator. The National Taxpayer Advocate is also unaware of any servicewide effort by the Deputy Commissioner, International to coordinate service for U.S. taxpayers abroad. Most importantly, while the IRS states that it will consider the views of the National Taxpayer Advocate, and cites several “servicewide” initiatives to address international taxpayer service, including an FBAR Communication Team, none of these initiatives have included representatives of the Taxpayer Advocate Service.

The FBAR and Title 31 Helpline is a commendable effort that the IRS should extend to other international issues, with special IRS email addresses available for different international tax law topics. The National Taxpayer Advocate also applauds the free voluntary return preparation for military personnel abroad. The IRS should find partners among organizations of U.S. citizens and expand VITA to civilian U.S. taxpayers overseas. This effort would not require additional resources because about 66 VITA sites are co-located with U.S. military installations abroad and can provide free services to civilians.

The National Taxpayer Advocate also commends the IRS for establishing a pilot program to exchange information by secure email with other federal agencies, state and local jurisdictions, government contractors, and banks. However, the IRS does not commit to use this technology to improve basic services for U.S. taxpayers abroad.

While we are appreciative of the IRS’s agreement to consider working with the Department of State to deliver VSD and other taxpayer services through embassy and consular facilities, the National Taxpayer Advocate encourages the IRS to set definitive timeframes for establishing VSD and extending secure email to all international taxpayer communications. The IRS should work with TAS and extend the TAS VSD pilot to taxpayers abroad who now have no means of receiving face-to-face assistance from an advocate. Finally, the IRS should support the pilot proposed by TAS to use secure email to international taxpayers.

The IRS comments did not consider our recommendations to simplify income tax reporting for U.S. taxpayers abroad who have no U.S. tax liability or have only a minimal liability. The IRS should also test self-serve electronic options for these taxpayers, including Telefile, free filing by Internet (Netfile), and online access to IRS accounts.

The National Taxpayer Advocate reiterates her recommendation to extend in-person and toll-free telephone service to U.S. taxpayers residing in Mexico. The IRS’s reluctance to reopen its Mexico City post is disappointing, considering that Mexico is the country with the largest number of U.S. taxpayers abroad, yet is without a single venue for them to receive help face-to-face. The IRS cites as a reason for its position that the Competent Authority

<sup>56</sup> W&I, Research & Analysis, *Understanding the International Taxpayer Experience: Service Awareness, Use, Preferences, and Filing Behaviors*, Research Study Report (Feb. 2010); W&I, Research & Analysis, Focus Group Testing Report: *Customer Service Needs of U.S. Taxpayers Living Abroad*, Project # 3-08-07-S-017T (Dec. 2008); W&I International Taxpayer Topline Report 5, Pacific Consulting Group (Dec. 2009) (Survey Report).

can manage treaty relationships from its office in Florida, but as the IRS admits, tax attaché responsibilities are not limited to Competent Authority assistance.

In the course of preparing this report, the National Taxpayer Advocate requested a full copy of the study entitled “IRS Tax Attaché Expansion Proposal,” which was conducted in response to the National Taxpayer Advocate’s recommendation in the 2009 Annual Report to Congress.<sup>57</sup> The only document provided — the IRS Tax Attaché Posts Expansion Proposal, Executive Summary, *Increase the Number of Foreign Posts of Duty* (undated) — makes a strong case for post expansion and then abruptly ends with a handwritten, anonymous statement that due to budgetary considerations the expansion is not warranted.<sup>58</sup> The National Taxpayer Advocate believes that American taxpayers have a right to know the unaltered results of this study, so their representatives in Congress can make an informed decision about whether to fund the expansion. At the very least, the IRS should provide funding to co-locate Local Taxpayer Advocates with its posts abroad.<sup>59</sup>

## Recommendations

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

1. Simplify tax return and information reporting forms for individual U.S. taxpayers abroad.
2. Expand self-serve options, including TeleFile, fax, and Free File, and develop a free website application from IRS.gov (NetFile).
3. Extend telephone access to the existing Accounts Management function and the National Taxpayer Advocate (NTA) toll-free lines for the continental U.S. to taxpayers in Canada and Mexico.
4. Pilot secure email communications, virtual service delivery, and access to the MyIRS account application for international taxpayers, including answers to account-specific questions and access to TAS.
5. Establish a tax attaché office in Mexico.
6. Partner with the Department of State to train embassy and consulate staff to provide a full range of taxpayer services, including assistance with preparation of tax returns, similar to what the Social Security Administration does for beneficiaries overseas.

<sup>57</sup> IRS response to TAS research request (Nov. 22, 2011). See also National Taxpayer Advocate 2009 Annual Report to Congress 134-154; National Taxpayer Advocate 2008 Annual Report to Congress 141-157; IRS response to TAS recommendations, Department of Treasury, JAMES TAS--09-ARC-001MSP, 7-3-1.

<sup>58</sup> Email from LB&I official to TAS (Oct. 11, 2011).

<sup>59</sup> See Most Serious Problem: *Globalization Requires Greater Internal IRS Coordination of International Taxpayer Service*, *infra*.

MSP  
#9**Small Businesses Involved In International Economic Activity Need Targeted IRS Assistance****RESPONSIBLE OFFICIALS**

Faris Fink, Commissioner, Small Business/Self-Employed Division  
 Heather C. Maloy, Commissioner, Large Business and International Division  
 Richard E. Byrd Jr., Commissioner, Wage and Investment Division  
 Beth Tucker, Deputy Commissioner, Operations Support  
 Frank Keith, Chief, Communications and Liaison

**DEFINITION OF PROBLEM**

As a result of globalization, an increasing number of taxpayers, including small businesses, engage in international transactions.<sup>1</sup> While complex international tax law and reporting requirements fully apply to small businesses involved in cross-border activity, the IRS has no comprehensive outreach strategy to help these businesses meet their tax obligations.<sup>2</sup> Because these taxpayers may have trouble understanding international tax rules and may not be able to afford professional representation, they need targeted taxpayer service.<sup>3</sup> In addition, the President's National Export Initiative requires all federal agencies to facilitate exports by U.S. companies, especially small businesses and first-time exporters, and to help these businesses overcome administrative hurdles.<sup>4</sup> 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 available to large and midsize businesses.

**ANALYSIS OF PROBLEM****Background**

An estimated 253,000 small businesses made up 91.7 percent of all known exporters in calendar year 2009.<sup>5</sup> During the same period, approximately 163,000 small businesses comprised about 90.8 percent of all U.S. importers. According to the Small Business Administration (SBA), from 2003 to 2010, U.S. small businesses' exporting activity

<sup>1</sup> Memorandum for Secretary Geithner from J. Russell George, Treasury Inspector General for Tax Administration, *Management and Performance Challenges Facing the Internal Revenue Service for Fiscal Year 2011* 13 (Oct. 15, 2010).

<sup>2</sup> Small businesses involved in cross-border activity include U.S. taxpayers with assets of \$10 million or less and located abroad or engaged in international business transactions. For the list of international returns, see generally IRM 21.8.1 (Aug. 12, 2011) and IRM 21.8.2 (Sept. 9, 2011).

<sup>3</sup> A 2004 Small Business Administration study reported that the inability of small businesses to fully comprehend the complex international tax rules, or to obtain costly legal representation to reduce their U.S. tax liabilities, may have contributed to small firms with less than \$10 million in revenues not realizing the full benefits of the foreign tax credit. Innovation Information Consultants, Inc. (study for U.S. Small Business Administration), *The Impact of Tax Expenditure Policies on Incorporated Small Businesses* 4 (Apr. 2004).

<sup>4</sup> National Export Initiative, Exec. Order No. 13534, 75 Fed. Reg. 12433 (Mar. 11, 2010).

<sup>5</sup> U.S. Census Bureau, Profile of U.S. Importing and Exporting Companies, 2008-2009 (Apr. 12, 2011), at <http://www.census.gov/foreign-trade/Press-Release/edb/2009/2009Highlights.pdf> (last visited Nov. 4, 2011). The study defines a company as small if having between zero and 99 employees.

increased about 80 percent to account for nearly \$500 billion in annual sales and about 30 percent of America's export revenues.<sup>6</sup> Between 2004 and 2008, U.S. corporate income tax returns filed with Form 1118, *Foreign Tax Credit - Corporations*, increased by 12.8 percent. In the same period, returns filed with Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*, increased by 18.2 percent.<sup>7</sup>

The National Taxpayer Advocate discussed the compliance challenges facing small businesses involved in international economic activity in the 2009 Annual Report to Congress and made several recommendations to alleviate burden for these taxpayers.<sup>8</sup> However, the IRS has been slow to address those concerns.

**U.S. Small Businesses and Entrepreneurs Involved in International Economic Activity Need Comprehensive Industry and Country-Specific Outreach and Education Materials.**

The IRS does not have a comprehensive outreach strategy specifically targeting small businesses with international operations or even a dedicated web page for these taxpayers. By the IRS's own admission, there are a "myriad of pages" dealing with specific industries and international activities.<sup>9</sup> As discussed in the 2009 Annual Report to Congress, the IRS has 43 publications totaling 1,212 pages that 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.

The IRS does not offer a separate publication or targeted assistance to small businesses involved in international activity as it does, for example, to the construction business, gas retailers, or the auto industry.<sup>10</sup> Nor does the IRS provide international reporting information or links to relevant forms and instructions for start-up international businesses on its website.<sup>11</sup> The first three links on the IRS.gov landing page for international businesses are devoted to the Foreign Account Tax Compliance Act (FATCA), the international tax gap, and foreign athletes and entertainers.<sup>12</sup> International small businesses are left to navigate the complex rules or regulations on their own or hire a tax professional, or face severe penalties

<sup>6</sup> Karen Gordon Mills, Administrator of the U.S. Small Business Administration (SBA), *Taking Your Small Business Customers International* (Oct. 15, 2010), at <http://www.sba.gov/administrator/7390/6086> (last visited July 19, 2011). See also SBA Office of Advocacy, *The Small Business Economy: A Report to the President* 37 (2010).

<sup>7</sup> LB&I FY 2011 Business Plan 6.

<sup>8</sup> National Taxpayer Advocate 2009 Annual Report to Congress 134-154.

<sup>9</sup> *Id.* at 149 (IRS Comments to Most Serious Problem: U.S. Taxpayers Located or Conducting Business Abroad Face Compliance Challenges).

<sup>10</sup> See, e.g., IRS Pub. 3780, *Tax Information for Small Construction Business* (Nov. 2003). See also IRS, Construction Tax Center, at <http://www.irs.gov/businesses/small/industries/article/0,,id=185182,00.html>; IRS, Automotive Tax Center, at <http://www.irs.gov/businesses/small/industries/article/0,,id=183642,00.html>; IRS, Gas Retailers Tax Center, at <http://www.irs.gov/businesses/small/industries/article/0,,id=185190,00.html> (last visited Oct. 11, 2011).

<sup>11</sup> See Small Business and Self-Employed Tax Center - Your Small Business Advantage, at <http://www.irs.gov/businesses/small/index.html> (last visited July 31, 2011).

<sup>12</sup> IRS, Tax Information for International Businesses, at <http://www.irs.gov/businesses/international/index.html> (last visited July 31, 2011).

for noncompliance.<sup>13</sup> In contrast, the SBA has a dedicated office and numerous materials to assist U.S. small businesses with international operations.<sup>14</sup>

A good starting point would be a survey of needs and preferences of international small businesses and a new research project identifying the customer base.<sup>15</sup> Based on the study results, the IRS should fine-tune outreach and education materials for different groups of small businesses with international operations by type of business (trade, manufacturing, services, etc.) and by country of operation for the largest trading partners such as Canada, Mexico, China, Japan, and the United Kingdom.<sup>16</sup>

### **U.S. Small Businesses and Entrepreneurs Involved in International Economic Activity Need Special Assistance and Simplified Information Reporting.**

U.S. small businesses and entrepreneurs involved in international transactions are subject to burdensome information reporting requirements and may face significant penalties for even inadvertent noncompliance.<sup>17</sup> An example of the burden facing U.S. taxpayers who conduct business through a foreign corporation that they significantly own or control is Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*.<sup>18</sup> Form 5471 is four pages long, not including Schedules J, M, and O. The instructions are 16 pages long. *According to the IRS's own estimates, a small business taxpayer might easily need three work weeks to complete and file this form.*<sup>19</sup> Many international small businesses cannot afford professional assistance to comply with procedural and reporting requirements, and it should not be necessary. These taxpayers, which are most vulnerable to missing a filing deadline or a required form and potentially incurring penalties, need simplified information reporting and free filing assistance.

<sup>13</sup> See Preface 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*, *supra*.

<sup>14</sup> SBA, Office of International Trade, at <http://www.sba.gov/about-offices-content/1/2889/about-us/2903> (last visited July 26, 2011). SBA also has a separate page devoted to importing and exporting, at <http://www.sba.gov/category/navigation-structure/starting-managing-business/managing-business/exporting-importing> (last visited Oct. 11, 2011).

<sup>15</sup> See, e.g., IRS, W&I Research Study Report, *Understanding the International Taxpayer Experience: Service Awareness, Use, Preferences, and Filing Behaviors* (Feb. 2010); IRS, Small Business/Self-Employed Division (SB/SE) Research – Philadelphia, Project # 05.02.001.03, International Taxpayer Research Project 7 (Aug. 2003).

<sup>16</sup> SBA Office of Advocacy, *The Small Business Economy: A Report to the President* 42 (2010). There are 60 tax treaties with 68 countries, but the IRS has only one country-specific publication, which addresses the U.S. – Canada tax treaty. See IRS Pub. 597, *Information on the United States - Canada Income Tax Treaty* (Sept. 2011).

<sup>17</sup> See, e.g., Controlled Foreign Corporation (CFC), Controlled Foreign Partnership (CFP), and Passive Foreign Investment Company (PFIC) information reporting (Forms 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*; 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*; 926, *Return by a U.S. Transferor of Property to a Foreign Corporation*; 8865, *Return of U.S. Persons with Respect to Certain Foreign Partnerships*; 8621, *Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*).

<sup>18</sup> See generally IRC §§ 951-965 (addressing the taxation of shareholders of Controlled Foreign Corporations (CFCs)).

<sup>19</sup> See instructions to IRS Form 5471 (2008). The estimated burden for those filing this form is 82 hours, 45 minutes for recordkeeping, 16 hours, 14 minutes for learning about the law or the form, and 24 hours, 17 minutes for preparing and sending the form to the IRS. The total burden adds up to 123 hours and 16 minutes, or about 15.4 eight-hour work days.

In March 2010, the President created the National Export Initiative to help U.S. companies — especially small businesses — overcome “the hurdles to entering new export markets, by assisting with financing, and in general by pursuing a government-wide approach to export advocacy abroad.”<sup>20</sup> The Initiative was designed to increase “exports of goods, services, and agricultural products,” and to “create good high-paying jobs.” The National Taxpayer Advocate believes the IRS should actively participate in this Initiative and make it a part of a servicewide international taxpayer service strategy.<sup>21</sup> It should facilitate small business involvement in international transactions and export activities by providing a specialized technical assistance program and by simplifying information reporting, especially for first-time exporters and start-up businesses.<sup>22</sup> This special assistance may include a dedicated phone line, a small business export tax center on the IRS website — a one-stop service approach offering virtual meetings with IRS employees, interactive tax law assistance and simplified online return filing — as well as walk-in sites and workshops for small businesses involved in export activity.

**U.S. Small Businesses and Entrepreneurs Involved in International Economic Activity Need Affordable or Low-Cost Access to Pre-filing and Advance Pricing Agreement Programs Similar to Those Available to Large Businesses.**

While the IRS continuously improves and realigns programs for large international businesses, most of them are either unavailable or too costly for small businesses.<sup>23</sup> For example, the Pre-filing Agreement Program (PFA), Compliance Assurance Process (CAP), and Quality Examination Process (QEP) are available only to large businesses, while the Fast Track Settlement (FTS) is offered to small business taxpayers at a limited number of U.S. locations.<sup>24</sup> Only the advance pricing agreement (APA) program is available to small businesses involved in international transactions.<sup>25</sup> The IRS acknowledges that “the complexity or novelty of transfer pricing issues do not necessarily depend on the dollar volume of transactions, but small business taxpayers have lesser transfer pricing experience and resources.”<sup>26</sup> However, it charges a \$22,500 user fee for the APA program that makes it cost-prohibitive for many.<sup>27</sup> The IRS also charges a user fee for an international letter ruling up to \$14,000.<sup>28</sup> In contrast, the Canada Revenue Agency established a reduced fixed fee of

<sup>20</sup> National Export Initiative, Exec. Order No. 13534, 75 Fed. Reg. 12433 (Mar. 11, 2010).

<sup>21</sup> See Most Serious Problem: *Globalization Requires Greater Internal IRS Coordination of International Taxpayer Service*, *infra*.

<sup>22</sup> The IRS has broad authority to prescribe the time and manner in which taxpayers file returns and the format of various required forms. See, e.g., IRC §§ 6001, 6011.

<sup>23</sup> IRS, *IRS Takes Next Steps in International Realignment; Bolsters Transfer Pricing Compliance Programs and International Coordination*, IR-2011-81 (July 27, 2011).

<sup>24</sup> Rev. Proc. 2009-14, 2009-1 C.B. 324; Rev. Proc. 2003-40, 2003-1 C.B. 1044; Announcement 2005-87, 2005-2 C.B. 1144; IRS Pub. 4837 (Oct. 2010). FTS is available to small business taxpayers Chicago, IL; Houston, TX; St. Paul, MN; Philadelphia, PA; central New Jersey; and San Diego, Laguna Niguel, and Riverside, CA. Announcement 2011-5, 2011-4 I.R.B. 430.

<sup>25</sup> See Rev. Proc. 2006-9, 2006-1 C.B. 278; Rev. Proc. 2008-31, 2008-1 C.B. 1133.

<sup>26</sup> 2010 APA Statutory Report, IRS Announcement 2011-22, 2011-1 C.B. 672.

<sup>27</sup> The regular APA user fee is \$50,000. See Rev. Proc. 2006-9, 2006-1 C.B. 278, § 4.12.

<sup>28</sup> The IRS also charges a \$50,000 for a pre-filing agreement. See Treas. Reg. § 301.9100-1; Rev. Proc. 2011-1, Appendix A, 2011-1 I.R.B. 1. See also National Taxpayer Advocate 2007 Annual Report to Congress 66 (Most Serious Problem: *User Fees: Taxpayer Service for Sale*).

\$5,000 (Canadian) for small businesses participating in its APA program, and the Mexican Internal Revenue Service began issuing free letter rulings on international tax issues.<sup>29</sup>

In the 2009 Annual Report to Congress, the National Taxpayer Advocate recommended that the IRS extend the pre-filing agreement program to small business taxpayers involved in international transactions and reduce filing fees for the APA program for businesses with assets of \$10 million or less. The IRS explained its disagreement with the recommendation to open the pre-filing agreement program to small business taxpayers by saying “[i]t is not appropriate to use a pre-filing agreement (PFA) to clarify for the taxpayer an issue that has numerous legal complexities.”<sup>30</sup> It also commented that the PFA user fee will be cost-prohibitive for most small businesses. While it did not object to lowering the user fees for the “smallest taxpayers” willing to participate in the APA program, it did not change the APA user fee schedule. IRS data show the number of small business taxpayer APAs that it completed decreased from the maximum of 19 in tax year (TY) 2006 to only seven in TY 2010, while the average combined time for the IRS to complete a small business taxpayer APA steadily increased from an average of 8.1 months in TY 2000 to over 34.5 months in TY 2010.<sup>31</sup>

The National Taxpayer Advocate believes U.S. small businesses and individual entrepreneurs deserve the same level of confidence large and mid-sized businesses have in the finality of a tax position on a return. As a first step, the IRS should deliver on its promise to reduce APA user fees for the “smallest” taxpayers. As part of its servicewide international taxpayer service strategy, the IRS should consider reducing or eliminating letter ruling fees on international issues for small business taxpayers, and implementing pilots to test the scope of raised issues, the possibility of cost reduction, and the desirability of making programs available to large businesses accessible to small business taxpayers. TAS offers its assistance in this effort.

## CONCLUSION

The National Taxpayer Advocate is concerned about the IRS’s continued neglect of U.S. small businesses and entrepreneurs involved in international transactions. The IRS should substantially improve service for small business taxpayers by providing special assistance to new international small businesses, country-specific education and outreach materials, simplified information reporting for small businesses and overseas American entrepreneurs, and free or nominal-cost pre-filing and post-filing programs for small businesses

<sup>29</sup> See Shiraj Keshvani, *Canada’s APA Program*, presentation at the ABA Section of Taxation 2009 Joint Fall CLE Meeting, Chicago, IL (Sept. 25, 2009); Fourth Annual U.S. - Latin American Tax Planning Strategies Conference, Government Roundtable Report 8-9, Miami, FL (June 17, 2011). To receive a letter ruling from the Mexican Internal Revenue Service, which is binding of the government but not on the taxpayer, the taxpayer simply has to send an email with a substantive question including all relevant facts to the taxing authority. Tax letter rulings may apply either to future or past transactions or tax positions, but are limited to real and concrete situations. Taxpayers may disagree with the government’s interpretation and withdraw from the program.

<sup>30</sup> National Taxpayer Advocate 2009 Annual Report to Congress 149.

<sup>31</sup> Annual APA Statutory Reports, at <http://www.irs.gov/businesses/corporations/article/0,,id=96191,00.html> (last visited Oct. 19, 2009). Given the number of processed small business APAs from TY 2000 to TY 2010, the APA program was largely underutilized by the small business community, perhaps, due to excessive user fees.

involved in international activity. Once again, TAS offers its assistance to the IRS in finding creative, innovative, and cost-efficient ways to improve service to these taxpayers.<sup>32</sup>

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

1. Survey the needs and preferences of U.S. small businesses involved in international transactions and conduct a new study in collaboration with TAS Research to properly identify this taxpayer population and its needs.
2. Develop publications, education, and outreach materials for small businesses involved in international transactions, including start-up businesses (regardless of form, *i.e.*, corporation, partnership, limited liability company, or sole proprietorship), and country-specific materials for major trading partners, similar to the publication addressing the U.S.–Canada tax treaty.
3. 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.
4. Simplify information reporting for U.S. small businesses and entrepreneurs involved in international transactions.
5. Reduce filing fees for the APA program and letter rulings on international issues for small businesses with assets of \$10 million or less.
6. Test pilots of the PFA program and other programs available for large businesses, for small businesses but with reduced fees.

### IRS COMMENTS

The IRS recognizes the issues faced by small businesses engaged in international economic activities and we continue to look for opportunities to improve service delivered to this taxpayer base.

As previously discussed, last year, the IRS reorganized the office of the Deputy Commissioner, International (LB&I) to align international technical professionals within a single office to better identify, address and resolve significant compliance issues faced by both individuals and businesses operating across borders. This realignment was driven in large part by recognition of the complexity of the tax law applicable to taxpayers engaged in international activities and investments and the commensurate challenges to the IRS in communicating and enforcing those legal complexities. The Deputy Commissioner, International is responsible for coordinating the IRS's efforts in this area across all IRS Business Operating Divisions to ensure that the IRS' international strategy is aligned, balanced, and coordinated.

<sup>32</sup> National Taxpayer Advocate 2009 Annual Report to Congress 134-154.

The IRS will consider developing a comprehensive outreach strategy to help small businesses meet their international tax obligations, and we will consider the views included in the National Taxpayer Advocate's report in this effort.

The IRS continues to look for ways to assist small business taxpayers engaged in domestic and international activities and we have taken a number of steps in this area. For example, the IRS has recently expanded the Fast Track Settlement (FTS) program to some small businesses. In Announcement 2011-5, 2011-4 I.R.B. 430,<sup>33</sup> the IRS announced the opportunity for small business/self-employed taxpayers to use FTS to expedite case resolution in Chicago, IL; Houston, TX; St. Paul, MN; Philadelphia, PA; central New Jersey; and San Diego, Laguna Niguel, and Riverside, CA. Additional locations may be identified and added to this program by mutual agreement between SB/SE and the Office of Appeals.

The IRS will continue to explore whether additional special programs, as well as tailored education and outreach, are needed for small businesses. The report of the National Taxpayer Advocate has suggested a survey be conducted as a starting point to determine the needs and preferences of international small businesses in addition to conducting a new research project to identify the customer base. We will consider this option as we move forward.

We will continue to assess whether improvements can be made; however, it should be recognized that the IRS currently provides assistance to international taxpayers in a variety of ways. IRS Media & Publications (M&P), part of the IRS's Wage & Investment division's CARE organization, provides IRS-wide support for publishing and distribution services, including outreach and education products for all international taxpayers. M&P is participating in an agency-wide group that is working to improve services to international taxpayers. In brief, M&P:

- Authors and publishes tax products for U.S. and international taxpayers. These products are available to all taxpayers, regardless of where they live and work, through "Forms and Publications" on IRS.gov.
- Administers a small bulk forms distribution program for embassies and military bases.
- Provides mail order fulfillment services to national and international requesters.

The Tax Forms and Publications (TFP) office develops technical tax law forms, instructions, and publications in support of needs identified by the business units. TFP also contains the Multilingual and Agency Services office, which maintains and enhances web-tools for international taxpayers. M&P will continue to collaborate with the appropriate business unit to produce published documents (*e.g.*, forms, publications, and notices) that facilitate tax administration and reduce taxpayer burden.

<sup>33</sup> IRS, *Extension of Fast Track Settlement for SB/SE Taxpayers Pilot Program* (Jan. 24, 2011), available at [http://www.irs.gov/irb/2011-04\\_IRB/ar10.html](http://www.irs.gov/irb/2011-04_IRB/ar10.html).

The IRS will also continue to assess whether simplified information reporting for small businesses is feasible and appropriate. It is important to note, however, that the reduced burden of simplifying the information reporting forms must be balanced with the compliance risks of additional enforcement challenges. For example, a Form 5471 contains a balance sheet and income statement for the foreign corporation enabling the IRS to evaluate whether potential non-compliance exists. Such information may also be of significant use to a taxpayer preparing a U.S. tax return or preparing U.S. financial statements. A Form 5471 properly completed and attached to the original return informs the IRS of the scope and impact of a foreign corporation's operations, and serves as a very relevant source of information as the IRS decides whether to examine or accept returns as filed.

With respect to the proposal to allow a reduced APA filing fee, we will continue to take the recommendation into account. Any plan to increase the number of small business taxpayer APAs must take into account the potential impact on the Program as a whole, including the potential need for additional resources and the potential effect on case processing times. Any significant increase in caseloads, without a commensurate increase in resources could lead to further backlogs and/or undesirable structural changes. As part of the APA Program's announced merger with the U.S. Competent Authority, the IRS is addressing a number of strategic issues, including small business APAs.

With respect to the recommendation to test pilot the pre-filing agreement program and other programs available for large businesses for small businesses, but with reduced fees, we question whether the magnitude of the problems faced by small businesses engaged in international activities can be adequately addressed by programs designed to clarify for the taxpayer an issue that has numerous legal complexities. A PFA is generally entered into to resolve, in advance of filing, the determination of facts affecting a tax position on a return, the application of well-established legal principles to known facts, or the methodology used by the taxpayer to determine an appropriate amount of income, deduction, allowance or credit.

A PFA program for small businesses would require significant additional IRS resources. Due to the current fiscal and staffing constraints, at this time, the IRS is not in a position to conduct a pilot program that offers reduced PFA user fees for small businesses. Inquiries received from small businesses regarding the PFA program indicate issues that would be considered for acceptance are complex issues and would take as much, if not more, resources to address than the typical issues submitted by large businesses.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS recognizes the burdens faced by small businesses engaged in international economic activities and that it agrees to consider her preliminary recommendations. She also commends the IRS for expanding the Fast Track Settlement program to some small businesses and encourages the IRS to make FTS available at more offices around the country.

However, the IRS comments confirm the lack of a coordinated taxpayer service strategy for small business taxpayers involved in international economic activity. The efforts cited by the IRS, such as Media & Publications or Tax Forms and Publications activities “for U.S. and international taxpayers,” do not offer separate, specific programs addressing these businesses’ needs and preferences. The National Taxpayer Advocate is not aware of any servicewide effort by the Deputy Commissioner, International to coordinate taxpayer service to small businesses involved in international activity. This lack of commitment to improving service for small businesses, which make up more than 90 percent of all known U.S. exporters and importers, may undermine the concerted government effort to increase “exports of goods, services, and agricultural products” by small businesses and to “create good high-paying jobs.”<sup>34</sup> The National Taxpayer Advocate believes the IRS cannot delay the development of dedicated services for these taxpayers, including a small business exporting center on IRS.gov, and must fine-tune assistance to meet the needs and preferences of small businesses with international operations.

The National Taxpayer Advocate also believes simplified information reporting should not harm the IRS’s ability to evaluate potential noncompliance. The IRS should employ a data-driven approach to simplification based on the number of noncompliant small businesses that were audited because of evaluation of a specific information reporting form (*e.g.*, Form 5471) and the amount of unpaid liabilities collected based on the form. The IRS should use its broad authority to require information reporting wisely, without impairing small businesses’ ability to comply. These taxpayers should not be forced out of international economic activities by prohibitive costs of compliance, including professional representation.

We agree with the IRS’s observation that a reduced APA filing fee might lead to increased filings. An increase in filings would indicate that more small business taxpayers need this service with a more reasonable fee structure. It is almost certain that the resulting increase in filings will require more resources to avoid additional backlogs, given that it currently takes an unacceptably long average of almost three years to process APAs with the existing resources.

While the IRS acknowledges that small businesses are facing complex international tax issues that “would take as much, if not more, resources to address than the typical

<sup>34</sup> National Export Initiative, Exec. Order No. 13534, 75 Fed. Reg. 12433 (Mar. 11, 2010).

issues submitted by large businesses,” it continues to effectively deny these taxpayers the pre-filing assistance that large businesses receive. While we agree that these initiatives may require more resources, we believe that there is sufficient data and analysis available today that would enable the IRS to make a compelling and convincing case for additional funding in this area, so that U.S. small businesses can be competitive in a global economy without fear of running afoul of the tax laws.

## Recommendations

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

1. Survey the needs and preferences of U.S. small businesses involved in international transactions and conduct a new study in collaboration with TAS Research to properly identify this taxpayer population and its needs.
2. Develop publications, education, and outreach materials for small businesses involved in international transactions, including start-up businesses (regardless of form, *i.e.*, corporation, partnership, limited liability company, or sole proprietorship), and country-specific materials for major trading partners, similar to the publication addressing the U.S.–Canada tax treaty.
3. 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.
4. Simplify information reporting for U.S. small businesses and entrepreneurs involved in international transactions.
5. Reduce filing fees for the APA program and letter rulings on international issues for small businesses with assets of \$10 million or less.
6. Test pilot versions of the PFA program and other programs available for large businesses for small businesses, but with reduced fees.

MSP  
#10**Globalization Requires Greater Internal IRS Coordination of International Taxpayer Service****RESPONSIBLE OFFICIALS**

Faris Fink, Commissioner, Small Business/Self-Employed Division  
Heather C. Maloy, Commissioner, Large Business and International Division  
Joseph H. Grant, Acting Commissioner, Tax Exempt and Government Entities Division  
Richard E. Byrd Jr., Commissioner, Wage and Investment Division  
Chris Wagner, Chief, Appeals  
Beth Tucker, Deputy Commissioner, Operations Support  
Frank Keith, Chief, Communications and Liaison

**DEFINITION OF PROBLEM**

In recent years, the IRS has devoted substantial resources to improving international tax administration and responding to the challenges of globalization. However, the IRS's international tax administration strategy has focused on stepped-up enforcement without adequate coordination or a corresponding increase in service to international taxpayers. The IRS recently replaced the International Planning and Operations Council (IPOC), the only servicewide forum for addressing international taxpayer issues, with separate "bilateral" meetings between the Large Business and International (LB&I) division and each of the other divisions. The lack of efficient IRS-wide coordination of international taxpayer service may undermine international enforcement initiatives and discourage future compliance by taxpayers dealing with the complexity and procedural burden of the international tax rules.

**ANALYSIS OF PROBLEM****Background**

IRS Commissioner Douglas Shulman announced an agency-wide international initiative in 2008.<sup>1</sup> As part of that initiative, the IRS committed to improving tax administration to deal more effectively with the increasing globalization of individual and business taxpayers through servicewide cooperation in addressing emerging international issues, and collaboration on international matters throughout the IRS. In 2008, the IRS created the Servicewide Approach to International Tax Administration, which had taxpayer service as its number one strategic goal. It also contained initiatives to improve service options for international taxpayers, enhance outreach to these taxpayers, provide tools for earlier certainty on complex issues, and strive for burden reduction in the international tax law arena. In October 2009, the IRS realigned the Large and Mid-Size Business (LMSB) division to

<sup>1</sup> See *Tax Issues Related to Ponzi Schemes and an Update on Offshore Tax Evasion Legislation, Hearing Before the S. Comm. on Finance, 111th Cong.* (Mar. 17, 2009) (statement of Douglas Shulman, Commissioner, Internal Revenue Service).

create a more centralized organization dedicated to improving international tax compliance for individual and business taxpayers. As part of the organizational shift, the name of the IRS's large corporate unit — LMSB — was changed to the Large Business and International division.<sup>2</sup> The IRS's focus in this area also moved significantly away from taxpayer service and toward enforcement.<sup>3</sup> The new LB&I division was enhanced by adding about 875 compliance employees to an existing staff of nearly 600.<sup>4</sup>

### **The IRS Has Taken a One-Sided Approach to the Challenges of International Tax Administration, Focusing Mainly on Enforcement.**

While acknowledging the complexity of international tax law and the growth “in number and variety” of taxpayers with international activities, the IRS strategic plan is silent about planned improvements to international taxpayer service and focuses mainly on enhancing international enforcement.<sup>5</sup> The IRS Strategic Plan for 2009-2013 emphasizes the IRS's commitment to developing “deep expertise on specific international enforcement topics” and supporting employees “with the systems and processes needed to analyze data related to international enforcement efforts.” The plan generally identifies “priorities for increased enforcement resources,” using the following strategies:

- Expanding employee knowledge and awareness of international tax issues;
- Developing deep expertise and capabilities in key international issue areas;
- Enhancing coordination with treaty partners and international organizations; and
- Aggressively targeting areas of significant risk.<sup>6</sup>

Although the IRS has consolidated and realigned the compliance functions devoted to international taxpayers in the LB&I operating division (OD), it has not dedicated adequate resources to or adequately coordinated the international taxpayer service activities that are scattered throughout all ODs and functions.<sup>7</sup> Nor did the IRS request any substantial

<sup>2</sup> *IRS Realigns and Renames Large Business Division, Enhances Focus on International Tax Administration*, IRS News Release, IR-2010-88 (Aug. 4, 2010).

<sup>3</sup> While in 2008, the IRS's number one strategic goal was to improve taxpayer service, since 2009 the IRS focuses on international law enforcement initiatives. Cf. IRS LMSB, *Servicewide Approach to International Tax Administration, Strategic Goal 1: Improve Taxpayer Service*, at [http://lmsb.irs.gov/international/dir\\_compliance/global/sis1.asp](http://lmsb.irs.gov/international/dir_compliance/global/sis1.asp) (last visited Oct. 29, 2008), and IRS LMSB, *Servicewide Approach to International Tax Administration, Strategic Initiatives and FY2009 Priorities, IRS Goal: Enforce the Law to Ensure Everyone Meets Their Obligation to Pay Taxes*, at [http://lmsb.irs.gov/international/dir\\_compliance/global/sis1.asp](http://lmsb.irs.gov/international/dir_compliance/global/sis1.asp) (last visited Oct. 7, 2011).

<sup>4</sup> *IRS Realigns and Renames Large Business Division, Enhances Focus on International Tax Administration*, IRS News Release, IR-2010-88 (Aug. 4, 2010). Most of the additional examiners, economists, and technical staff were current employees who specialized in international issues within other parts of the LMSB operation.

<sup>5</sup> *IRS Strategic Plan 2009-2013, Objective 3: Meet the challenges of international tax administration*.

<sup>6</sup> *Id.*

<sup>7</sup> International Realignment, LMSB Division Talking Points (Aug. 2010). In October 2009, LMSB launched a new initiative called “Large Business and International Expansion,” which ultimately centralized all of the IRS's offshore and international compliance units in the LB&I division.

increases in funding for international taxpayer service in its budget requests for fiscal year (FY) 2010 to FY2012.<sup>8</sup>

As a result, the IRS's approach to international tax administration is one-sided. It is focused on stepped-up enforcement with no corresponding increase in services tailored to changing taxpayer demographics and the specific needs and preferences of different groups of international taxpayers.<sup>9</sup> These general categories include U.S. individuals working, living, or conducting 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.<sup>10</sup>

### **Increased Service Tailored to Different Categories of International Taxpayers Is Important for the Success of IRS Strategic Enforcement Initiatives in the International Arena.**

The Commissioner has recognized that international transactions are extremely complex and require consolidation of all IRS compliance resources.<sup>11</sup> However, the complexity of transactions, combined with the complexity of international tax law and procedural requirements, also affects the ability of international taxpayers to comply and creates a great need for IRS services.

In the United States, tax administration is largely based on voluntary compliance (*i.e.*, on taxpayers' willingness and ability to comply).<sup>12</sup> Voluntary compliance also depends on the fairness of tax administration, where service options are easily available and affordable for those making a good faith effort to comply. Burdensome reporting and record-keeping

<sup>8</sup> In FY 2011, the IRS requested an enforcement account increase of \$293.4 million, an increase of about \$121 million allocated to international compliance and only about \$1.7 million to international taxpayer services. IRS, *The Budget in Brief*, FY 2011. Similarly, in FY 2010, the IRS requested an increase of \$332.2 million "for investments in strong compliance programs, including a robust portfolio of international enforcement initiatives." Of the \$332.2 million increase, about \$128 million was requested for international compliance, of which \$3.1 million was for international service. IRS, *The Budget in Brief*, FY 2010. It appears that the IRS requests for enforcement spending for FYs 2010 and 2011 were funded in full (for FY 2011 – on FY 2010 levels). See Pub. L. No. 111-117 (Dec. 16, 2009); Pub. L. No. 112-10 (Apr. 15, 2011). For example, the approved FY 2010 budget included an additional 742 full time equivalents (FTEs) and \$104.11 million to support international enforcement, and only 42 FTE and \$3.12 million to support international taxpayer service. The approved FY 2011 budget did not fund the requested additional 30 FTE and \$1.78 million for international taxpayer service. IRS response to TAS research request (Nov. 22, 2011). For FY 2012, the IRS has requested \$72.6 million for international service and enforcement, of which about \$35 million is requested for Foreign Account Tax Compliance Act (FATCA) implementation, about \$15.8 million for increased international coverage, \$8.5 million for Criminal Investigation international expansion, \$8.8 million for international data analysis, and \$4.5 million for other direct costs (includes Appeals and Chief Counsel). Although the request is for "International Service and Enforcement," it appears that no additional funding is requested for international taxpayer service. IRS FY 2012 Budget Request, Congressional Budget Submission 10 (Feb. 14, 2011), at [http://www.treasury.gov/about/budget-performance/Documents/CJ\\_FY2012\\_IRS\\_508.pdf](http://www.treasury.gov/about/budget-performance/Documents/CJ_FY2012_IRS_508.pdf).

<sup>9</sup> See Introduction to Diversity Issues: *The IRS Should Do More to Accommodate Changing Taxpayer Demographics*, *infra*.

<sup>10</sup> See Most Serious Problems: *Individual U.S. Taxpayers Working, Living, or Doing Business Abroad Need Expanded Service Targeting Their Specific Needs and Preferences; Small Businesses Involved in International Economic Activity Need Targeted IRS Assistance; Foreign Taxpayers Face Challenges in Fulfilling U.S. Tax Obligations*, *supra*.

<sup>11</sup> IRS, Remarks of Douglas Shulman Before the Tax Executives Institute (Oct. 21, 2008), at <http://www.irs.gov/newsroom/article/0,,id=187958,00.html>.

<sup>12</sup> For example, of the \$2.3 trillion in tax revenue received by the IRS in FY 2010, direct enforcement revenue accounted for only \$57.6 billion, or about three percent. The remaining 97 percent resulted from voluntary compliance, though this includes some voluntary compliance that indirectly results from enforcement. IRS, *Fiscal Year 2010 Enforcement and Service Results* (Nov. 20, 2010), at [http://www.irs.gov/pub/irs-utl/2010\\_enforcement\\_results.pdf](http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf); Government Accountability Office (GAO), GAO-11-142, *Financial Audit: IRS's Fiscal Years 2010 and 2009 Financial Statements* 20 (Nov. 2010). See also *Complexity and the Tax Gap: Making Tax Compliance Easier and Collecting What's Due*, Hearing Before the S. Comm. on Finance, 112th Cong. (June 28, 2011) (statement of Nina E. Olson, National Taxpayer Advocate).

requirements, overly strict enforcement actions, poorly designed voluntary disclosure initiatives, and lack of transparency combined with inadequate taxpayer service may increase the burden on taxpayers who try to comply, and discourage future compliance.<sup>13</sup>

The four general categories of international taxpayers described above all need specific services and face varying compliance challenges, which are often unique to each group. Therefore, to achieve the result that increased enforcement is intended to achieve — bringing more international taxpayers into compliance and reducing the international tax gap — the IRS has to design services to meet these diverse needs and preferences.<sup>14</sup>

#### **Greater Internal Coordination of International Taxpayer Service Is Necessary for Achieving the Strategic Goals of International Tax Administration.**

The National Taxpayer Advocate is concerned that the IRS has shifted away from improvement and coordination of international taxpayer service. On February 25, 2011, the IRS dissolved the International Planning and Operations Council, the only servicewide forum for addressing international taxpayer issues, and replaced it with separate, “bilateral” meetings between LB&I and each of the other divisions.<sup>15</sup> The National Taxpayer Advocate voiced concerns that the dissolution of the council would have a negative effect on servicewide collaboration and customer service initiatives for international taxpayers, which cannot be addressed and resolved on a bilateral as opposed to a multilateral basis.<sup>16</sup> To date, the IRS has not offered bilateral meetings to TAS, the only IRS organization solely devoted to taxpayer rights and assistance.

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.<sup>17</sup> However, the IRS lacks a forum to share the information it receives through FTA about best practices in tax administration and taxpayer service with other ODs and functions, including TAS.<sup>18</sup> TAS is not represented in the IRS delegation to the FTA Taxpayer Services Subgroup.

<sup>13</sup> *Id.* See also Lewis I. Baurer, World Bank Group, *Tax Administrations and Small and Medium Enterprises (SMEs) in Developing Countries* 1 (July 2005); *Introduction to International Issues*, *supra*; Most Serious Problem: *IRS Offshore Voluntary Disclosure Program “Bait and Switch” May Undermine Trust for the IRS and Future Compliance Programs*, *infra*.

<sup>14</sup> See Most Serious Problems: *Individual U.S. Taxpayers Working, Living, or Doing Business Abroad Need Expanded Service Targeting Their Specific Needs and Preferences*; *Small Businesses Involved in International Economic Activity Need Targeted IRS Assistance*; *Foreign Taxpayers Face Challenges in Fulfilling U.S. Tax Obligations*, *supra*.

<sup>15</sup> Email from Deputy Commissioner (International), LB&I, to all BOD executives (Feb. 25, 2011).

<sup>16</sup> Email from the National Taxpayer Advocate to the Deputy Commissioner (International), LB&I (Feb. 25, 2011). To date, LB&I has not had a “bilateral” meeting with TAS.

<sup>17</sup> FTA was created by the Organization for Economic Cooperation and Development (OECD) Committee on Fiscal Affairs (CFA) in July 2002. FTA includes “the heads of revenue bodies and their teams” from 43 OECD and non-OECD countries. Currently, IRS Commissioner Douglas Shulman is the FTA chair.

<sup>18</sup> Many countries are now focused on reducing the administrative burden on taxpayers by simplifying and reducing compliance obligations and helping taxpayers interact with the revenue body in a more efficient, less costly way. FTA, Taxpayer Services Sub-group, Information Note, *Programs to Reduce the Administrative Burden of Tax Regulations 7* (follow-up report) (Mar. 2010).

Challenges facing international taxpayers call for greater internal coordination and strategic, servicewide direction of international taxpayer service.<sup>19</sup> Especially during the current economic downturn, the IRS should expand assistance to international taxpayers and re-establish the IPOC as a servicewide forum.<sup>20</sup> The National Taxpayer Advocate suggests that the IRS create an international taxpayer service subgroup within IPOC, addressing specific needs and compliance challenges of international taxpayers and coordinating international taxpayer service initiatives for all IRS functions. The IRS should also include TAS in developing its servicewide approach to international tax administration and its interactions with tax administration agencies from other countries.

### **International Taxpayers Need Local Taxpayer Advocates Abroad as They Consistently Seek Assistance from the Taxpayer Advocate Service.**

The IRS's international taxpayer service strategy does not include in-person return preparation or filing assistance for international taxpayers even though the IRS provides such services to domestic taxpayers through a network of Taxpayer Assistance Centers (TACs). In addition, the IRS Nationwide Tax Forums offer case resolution services to tax professionals and their clients in several American cities each year, but the IRS does not provide similar services abroad. Many international taxpayers may be unaware of the Tax Forums or unable to participate because of their locations or the cost of travel. The IRS maintains tax attaché posts in only four countries,<sup>21</sup> and even at these locations, the IRS attaches' main responsibilities include partner relationships, exchange of information agreements with foreign governments, and support of IRS investigations and examinations, with taxpayer service being an "important sideline."<sup>22</sup> Since 2008, the IRS has suspended overseas assistance tours at U.S. embassies because these tours were not cost-effective and "minimal in relation to the number of taxpayers living abroad."<sup>23</sup> International taxpayers lack a low-cost or free communication channel to reach the IRS for assistance.<sup>24</sup>

<sup>19</sup> Most Serious Problems: *Individual U.S. Taxpayers Working, Living, or Doing Business Abroad Need Expanded Service Targeting Their Specific Needs and Preferences; Small Businesses Involved in International Economic Activity Need Targeted IRS Assistance; Foreign Taxpayers Face Challenges in Fulfilling U.S. Tax Obligations, supra.*

<sup>20</sup> According to an International Monetary Fund expert, "[t]he first element in a tax compliance strategy for an economic crisis is to expand assistance to taxpayers." See John Brondolo, International Monetary Fund (IMF) Staff Position Note, *Collecting Taxes During an Economic Crisis: Challenges and Policy Options* 9 (July 14, 2009).

<sup>21</sup> The IRS posts are located in Frankfurt, Germany; London, United Kingdom; Paris, France; and Beijing, China. See IRM 4.30.3 (Oct. 1, 2010), *Overseas Posts*. At the same time, taxpayers with U.S. filing obligations may reside in 194 countries, and more than 60 territories, colonies, and dependencies of these countries. See U.S. Department of State Fact Sheet, *Independent Countries of the World*, at <http://www.state.gov/s/inr/rls/4250.htm> (last visited Oct. 11, 2011).

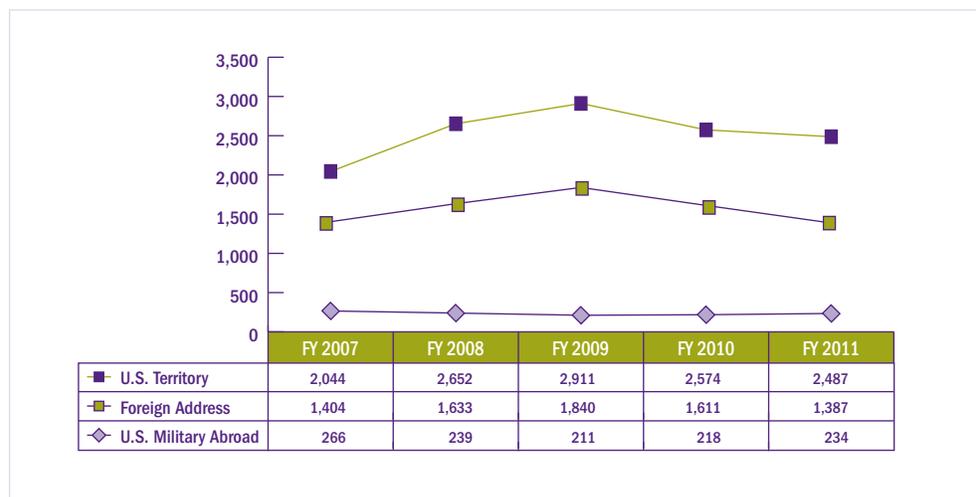
<sup>22</sup> IRM 4.40.3.2 (Oct. 1, 2010). See also IRS Today Vol. 4 No.1 (Jan./Feb. 2008), *A Day in the Life of the Paris Tax Attaché*, [http://wsep.ds.irsnet.gov/sites/co/candl/CLDocs/IC/irstoday/IRSToday\\_JanFeb\\_v10.pdf](http://wsep.ds.irsnet.gov/sites/co/candl/CLDocs/IC/irstoday/IRSToday_JanFeb_v10.pdf) (last visited Dec. 19, 2011).

<sup>23</sup> W&I is responsible for planning and implementing all overseas tours, including Volunteer Income Tax Assistance (VITA), Volunteer Embassy/Consulate Tax Assistance (VECTA) and taxpayer assistance. IRM 4.30.3.2 (Oct. 1, 2010). During the last overseas assistance tour from Feb. 28 to Mar. 31, 2008, IRS employees provided face-to-face assistance to 2,603 individuals at 21 U.S. embassies, spending approximately four days at each location. In 2007, W&I assisted 2,090 individuals at 25 locations. W&I responses to TAS research request (Oct. 14 and 19, 2009).

<sup>24</sup> The IRS does not provide international toll-free or voice-over-the-Internet (VOIP) service for international taxpayers, even for those calling from Canada or Mexico. See National Taxpayer Advocate 2008 Annual Report to Congress 141-157; National Taxpayer Advocate 2009 Annual Report to Congress 134-154.

Many international taxpayers who cannot obtain help from the IRS for various reasons seek the assistance of the Taxpayer Advocate Service.<sup>25</sup> TAS case receipts for taxpayers with military, U.S. territory, and foreign addresses or international issues ranged between 3,714 and 4,962 cases, showing consistent use of TAS between fiscal year (FY) 2007 and FY 2011 as described on Figure 1.10.1 below.<sup>26</sup>

**FIGURE 1.10.1, International TAS Cases in FYs 2007-2011**



A review of cases with foreign addresses reveals that about 16 percent of the inquiries came from three countries.<sup>27</sup> Twenty-two percent of all inquiries involved three primary issues:

- Identity theft;
- Original return processing; and
- Reconsideration of assessment (Substitute for Return, 602oB, Audit).<sup>28</sup>

<sup>25</sup> For a detailed discussion of compliance challenges of international taxpayers, see Most Serious Problems: *Individual U.S. Taxpayers Working, Living, or Doing Business Abroad Need Expanded Service Targeting Their Specific Needs and Preferences; Small Businesses Involved in International Economic Activity Need IRS Assistance the Most; Foreign Taxpayers Face Challenges in Fulfilling U.S. Tax Obligations*, *supra*.

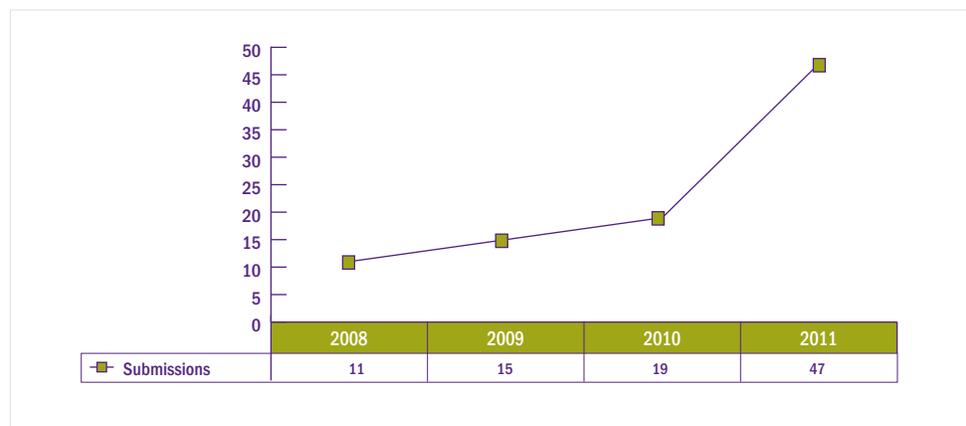
<sup>26</sup> Taxpayer Advocate Management Information System (TAMIS) database, FYs 2007–FY 2011.

<sup>27</sup> Canada submitted 7.1 percent of total inquiries, followed by the United Kingdom with 4.7 percent and Israel with 4.1 percent. These numbers do not include taxpayers with military or U.S. territory addresses. Taxpayer Advocate Management Information System (TAMIS) database, FYs 2007–2011.

<sup>28</sup> If the taxpayer failed to file a timely return, the IRS may have made a return, referred to as a substitute for return (SFR), as authorized by IRC § 6020(b), based on information reported to the IRS. The SFR may reflect income reported by third parties, but allow only the standard deduction, one exemption, and a filing status of single or married filing separately. See IRM 4.12.1.25.3 (Oct. 5, 2010); IRM 4.12.1.24.12 (Oct. 5, 2010).

TAS also operates the Systemic Advocacy Management System (SAMS), a database of systemic tax issues and information submitted by IRS employees and the public.<sup>29</sup> The number of SAMS submissions involving international issues increased more than threefold from CY 2008 to CY 2011, with a spike of 47 submissions during first three quarters of CY 2011 (thru Oct. 20, 2011), as shown on Figure 1.10.2 below.

**FIGURE 1.10.2, International SAMS Issue Submissions in CYs 2008–2011 (through Oct. 20, 2011)**



The inability of international taxpayers to access IRS services from abroad contributes to growing confusion and frustration about U.S. tax administration. TAS is the only IRS function exclusively devoted to resolving taxpayer issues with the IRS. While TAS has at least one office in all 50 states, the District of Columbia, and Puerto Rico, the international taxpayers' right to TAS assistance is constrained by the lack of Local Taxpayer Advocate (LTA) offices overseas.<sup>30</sup> Therefore, the IRS's international taxpayer service strategy should include creation of at least four LTA positions co-located with IRS offices abroad.<sup>31</sup> While international cases would still be worked in TAS offices in the United States, the overseas LTAs would devote their time to educating taxpayers abroad, resolving their compliance issues, and identifying systemic issues facing international taxpayers.<sup>32</sup> The IRS can free up funding for LTA positions abroad by reallocating funds from enforcement to taxpayer service.

<sup>29</sup> TAS, Systemic Advocacy Management System, at <http://www.irs.gov/advocate/article/0,,id=117703,00.html> (last visited Oct. 26, 2011). Systemic issues are eligible for SAMS submission if they impact segments of the taxpayer population, locally, regionally or nationally; relate to IRS systems, policies, and procedures; require study, analysis, administrative changes or legislative remedies; or involve protecting taxpayer rights, reducing or preventing taxpayer burden, ensuring equitable treatment of taxpayers or providing essential services to taxpayers.

<sup>30</sup> See generally IRC §§ 7803; 7811. See also IRS Pub. 1, *Your Rights as a Taxpayer*. The law requires at least one LTA in each state. International taxpayers cannot access TAS toll-free from abroad.

<sup>31</sup> TAS suggests having one LTA and one support employee (secretary) per office.

<sup>32</sup> See IRM 4.30.3.3 (Sept. 12, 2006) for tax attaché post jurisdictions.

## CONCLUSION

The National Taxpayer Advocate is concerned about the IRS's one-sided approach to international tax administration, which is focused 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. The failure to coordinate international taxpayer service strategy among all of the IRS's operating divisions and functions may undermine the effectiveness of international enforcement initiatives.

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

1. Reinstate the International Planning and Operations Council as a servicewide forum devoted to international taxpayer service and enforcement.
2. 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.
3. Include the National Taxpayer Advocate or her designee in the IRS's team for the Forum on Tax Administration Taxpayer Services Subgroup.
4. Provide funding for TAS to establish Local Taxpayer Advocate positions in each of the four existing tax attaché offices abroad and include such positions in future expansion of attaché offices.

## IRS COMMENTS

The IRS recognizes the need to increase internal IRS coordination of international taxpayer service. We have made a number of improvements in this area and continue to look for opportunities to improve service delivered to this taxpayer base.

As previously discussed, last year, the IRS reorganized the office of the Deputy Commissioner, International (LB&I) to align international technical professionals within a single office to better identify, address and resolve significant compliance issues faced by both individuals and businesses operating across borders. This realignment was driven in large part by recognition of the great high complexity of the tax law applicable to taxpayers engaged in international activities and investments and the commensurate challenges to the IRS in communicating and enforcing those legal complexities. The Deputy Commissioner, International is responsible for coordinating IRS efforts in this area across all IRS Business Operating Divisions to ensure that the IRS's international strategy is aligned, balanced, and coordinated.

Also as previously discussed, improving taxpayer services to U.S. taxpayers who work, live, and conduct business abroad is an important strategic goal for the office of the Deputy Commissioner, International and the IRS in general. As part of FY 2012 priorities, the International Executive team is committed to coordinate closely with Wage & Investment and the Director, e-Services to perform a thorough review of specific problems faced

by overseas taxpayers, identify modern options available to improve service, and make recommendations for implementing effective improvements. We will consider the views included in the National Taxpayer Advocate's report in this effort.

### Current IRS Efforts

The IRS has taken a number of steps throughout the operating divisions to better coordinate delivery of service to international taxpayers.

W&I Research & Analysis (WIRA) has been capturing and defining the service needs of international taxpayers through a portfolio of research designed to identify the demographic profile as well as the tax preparation and filing habits of international taxpayers, service channel preferences, potential barriers to service, and opportunities for service improvement. This multi-tiered approach to international research included demographic and tax filing profiles of international taxpayers, focus groups with tax practitioners who service international clients, interviews with the four international IRS Tax Attachés, interviews with U.S.-based multinational companies employing U.S. citizens working abroad, and the 2009 IRS Survey of International Taxpayers. The primary research resulted in the 2010 *Understanding the International Taxpayer Experience Research Study Report* and presents the first comprehensive analysis of the service needs of this growing, yet underserved, taxpayer segment.

As a result of WIRA's international research, two recommendations have been implemented. The first recommendation resulted in a Free File link being placed on the IRS.gov International Taxpayer page as well as a tag line identifying those software companies that support foreign addresses on the IRS.gov Free File page. The second recommendation resulted in a partnership with the international affinity group American Citizens Abroad (ACA) in an effort to reach additional taxpayers beyond the IRS's scope. ACA featured the report as well as the researchers on their website and throughout their organization. Additionally, ACA reached out to their international network to publicize the survey through an article in their newsletter. This partnership broadens the awareness of international tax obligations as well as creating a means of reaching a wider base of international taxpayers.

Currently a case is being presented for the rollout of an international interactive tax law application (ITA) as a result of a third recommendation from the report. The International Taxpayer Experience Report was shared with LB&I, who shared it with current Tax Attachés overseas as well as other employees. Additionally, the research was presented at the biannual servicewide 2010 Research Manager's Conference and the 2011 IRS Software Developers Conference, as well as to the IRS Free File Alliance.

Building on the success of the first phase of international taxpayer research, WIRA kicked off a second phase of research to further develop and refine the IRS's understanding of international taxpayer service needs, preferences, and behaviors. The focal point of this

second phase of research is the 2011 IRS Survey of Individuals Living Abroad, with its specific interest in international taxpayers' experiences, expectations, and preferred alternatives to an IRS international telephone line.

In an effort to reach a wider population of international taxpayers, WIRA used groundbreaking research methodology and resources, including the IRS non-filer database, U.S. Department of State Passport data, Certificate of Loss of Nationality data, and expatriate affinity groups to administer the 2011 survey to international filers and non-filers, non-resident aliens, overseas military personnel, and expatriates. With 1,753 unique responses from individuals living in 81 countries, WIRA has obtained feedback from previously never-before-reached populations on their unique compliance issues, service needs, and taxpayer burden. WIRA received an additional 157 survey responses from a survey link placed on the expatriate affinity group ACA website. A comprehensive report of the survey findings as well as updated demographic and tax filing profiles of international taxpayers is slated to be completed and released in spring 2012.

Furthermore, the IRS has formed an agency-wide group that is working to improve services to international taxpayers. One of the initial tasks was to summarize the support work currently done. In brief, IRS's Media & Publications function:

- Authors and publishes tax products for U.S. and international taxpayers. These products are available to all taxpayers, regardless of where they live and work, through "Forms and Publications" on IRS.gov.
- Administers a small bulk forms distribution program for embassies and military bases.
- Provides mail order fulfillment services to national and international requesters.

In addition, the IRS has identified actions for FY 2012 to improve services for international taxpayers. These include:

- Expanding products and services to meet the needs of limited-English proficient taxpayers.
- Focusing on delivering electronic publishing and providing electronic options for disseminating products in formats customer prefer.
- Creating user friendly URLs (product pages) that include content that clearly and succinctly describes the product's purpose and links to helpful html and pdf files.

### Current Taxpayer Service Programs for International Taxpayers

The following are current taxpayer services offered by the IRS to international taxpayers:

**In-person taxpayer services at four foreign posts led by Tax Attachés:** Taxpayer assistance is provided in London, Paris, Frankfurt, and Beijing. In addition, outreach events are conducted by each Tax Attaché in his or her designated countries of jurisdiction to enhance taxpayer assistance and treaty partner relationships.

The duties of the Tax Attaché include the provision of taxpayer service involving U.S. citizens, non-resident aliens, and entities and the presentation of outreach events with the Department of State, practitioner communities, business organizations, and other federal, state, and local agencies.

**Telephone service:** In July 2011, the IRS opened a new telephone helpline for questions about foreign bank account reports. The IRS FBAR and Title 31 Helpline connects practitioners and filers, both in the U.S. and abroad, with a team of specially-trained technicians, examiners, and specialists to answer technical questions about Title 31, the Bank Secrecy Act. They answer questions related to reports required by the Bank Secrecy Act, such as the FBAR.

The team employed traditional means of disseminating information by posting articles and updating Frequently Asked Questions on IRS.gov. Additionally, the team sought out new methods of reaching a wider audience, specifically filers residing abroad. Those methods included a June 1, 2011, FBAR Webinar, *Reporting Foreign Financial Accounts on the FBAR*, Twitter alerts, and an educational video, *When & How to Report Foreign Financial Accounts*, which was posted to IRS.gov. The Twitter alerts not only invited participation in the FBAR Webinar, but were also used to remind FBAR filers of the June 30 filing deadline.

It must be noted, however, that WIRA research reveals that “nearly 70 percent of survey respondents reported a preference for improving online services (*i.e.*, improve website interactivity specific to international tax issues) over improving the telephone service (*i.e.*, improve access by providing an international toll-free line).”

**Volunteer Income Tax Preparation Assistance:** The IRS provides free tax assistance and return preparation at its Volunteer Income Tax Assistance or Tax Counseling for the Elderly sites. In addition, the IRS provides the VITA/TCE sites with software, training materials, and support via email throughout the tax season. All volunteers in the VITA or TCE program have to certify on the IRS’ Link & Learn Taxes program. Link & Learn Taxes, *linking volunteers to qualify e-learning solutions*, is the IRS web-based program providing nine courses: Basic, Intermediate, Advanced, Military, International, Puerto Rico, and Foreign Student, along with a refresher course for returning volunteers, and two optional specialty courses on Cancellation of Debt and Health Savings Accounts. These courses, including the International and the Foreign Student courses, are available on IRS.gov.

**Free return preparation for U.S military living overseas:** To assist all military personnel living overseas, the IRS provides free tax assistance and return preparation at its VITA sites. For FY 2011, IRS had 66 VITA sites located overseas at U.S. military bases where volunteers prepared approximately 45,000 returns.

**Limited English Proficiency (LEP) Initiative:** The IRS, through its Volunteer Return Preparation Program (Volunteer Program), has established the LEP Initiative to assist

Hispanic, Asian and Russian speaking taxpayers file their taxes by increasing communication, education and services to the LEP community.

**Over the Phone Interpreter (OPI) Service and Pilot:** In 2009, the IRS implemented the Over the Phone Interpreter (OPI) Service, which is available at Taxpayer Assistance Centers throughout the United States. Currently, the IRS is piloting an OPI Service program for use at VITA/TCE sites nationwide. This program allows the IRS to serve LEP taxpayers by providing foreign language translation services to partners and volunteers at VITA/TCE sites. This pilot expands existing OPI services previously only available for use by IRS employees. The service, offered at no cost to taxpayers or participating partners, allows our partners/volunteers to communicate with LEP taxpayers at their sites in over 170 foreign languages, thereby facilitating the return preparation process

**Foreign Language Websites:** The IRS has two special websites available to taxpayers with limited English proficiency. The first, [www.irs.gov/espanol](http://www.irs.gov/espanol), includes access to many forms and publications in Spanish, including Publication 17, *El Impuesto Federal sobre los Ingresos (Your Federal Income Tax)*. The second, [www.irs.gov/languages](http://www.irs.gov/languages), has information in Chinese, Korean, Vietnamese, and Russian. The IRS provides a DVD on basic tax responsibilities in five languages — Spanish, Chinese, Russian, Vietnamese, and Korean. This DVD is available at no charge to anyone.

**Publications:** The IRS has created several publications to assist international taxpayers. Publication 4732, *Federal Tax Information for U.S. Taxpayers Living Abroad* is provided to all U.S. consulates and U.S. embassies. Publication 519, *U.S. Tax Guide for Aliens*, Publication 901, *Tax Treaties*, and Publication 597, *Information on the United States — Canada Income Tax Treaty*, are available on IRS.gov and also may be available at U.S. consulates and U.S. embassies.

The IRS continues to make improvements in this area. We will take into account the recommendations of the National Taxpayer Advocate as we move forward.

With respect to the recommendation to reinstate the International Planning and Operations Council as a servicewide forum devoted to international taxpayer service and enforcement, we do not believe that the challenges of coordinating international taxpayer service can be sufficiently addressed through this means given the focus and frequency of Council meetings. We have taken steps to expand our strategic approach to international compliance across Business Operating Divisions (BOD). The new international strategy, training programs, and knowledge management networks will accommodate our cross-BOD efforts. Although the IRS dissolved the International Planning and Operations Council, we have replaced it with “bilateral meetings” between LB&I and the other divisions.

We have made a number of improvements in coordination within the IRS. One recent achievement in summer 2011 occurred as a result of collaboration with Tax Exempt and Government Entities (TE/GE) to facilitate a servicewide strategic approach to global tax

administration. The outcome is a Memorandum of Understanding (MOU) describing a comprehensive, collaborative relationship between the two divisions. A representative of the Deputy Commissioner, International will participate in TE/GE's International Steering Committee, which plans and coordinates TE/GE's efforts to address international issues arising from cross-border activities of the TE/GE taxpayer base. At the working level, TE/GE experts will participate in LB&I's new International Practice Networks and will take advantage of LB&I's new international training programs. Together, the two divisions will further develop training and strategies designed to address the international issues confronted by TE/GE stakeholders. LB&I and TE/GE believe the collaborative, strategic approach captured by the new MOU will position the IRS well to address the challenges our global economy presents for tax administration.

The IRS will continue efforts to expand our strategic approach to international compliance by conducting "bilateral meetings" with all BODs as well as with TAS to address specific needs and compliance challenges of international taxpayers, and coordinate international taxpayer service initiatives for all IRS functions.

With respect to the recommendation relating to the Forum on Tax Administration, the role of the Taxpayer Services Subgroup is to enable the sharing of information about emerging and ongoing service delivery challenges among tax administrations. The work conducted by the Subgroup is shared with member countries and is distributed as appropriate within the IRS. The IRS has one delegate who serves as a member (and currently the Chair) of the Taxpayer Services group. That delegate is available to work with the National Taxpayer Advocate to share this work and to obtain the National Taxpayer Advocate's input and ideas about service delivery in tax administration.

With respect to the recommendation to establish Local Taxpayer Advocate positions in each of the four existing tax attaché offices abroad and include such positions in future expansion of attaché offices, we will consider options in this area, but do not believe that educating taxpayers abroad, resolving their compliance issues, and identifying systemic issues facing international taxpayers can be adequately addressed by placing single individuals in overseas offices. Establishing an LTA in each of the four existing tax attaché offices abroad will not afford every taxpayer an opportunity to avail himself or herself of Taxpayer Advocate services as not all taxpayers residing abroad are able to travel to the posts.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS recognizes the need to increase internal coordination of international taxpayer service and acknowledges improving taxpayer service to international taxpayers as an important strategic goal. We commend W&I Research & Analysis on its efforts to determine the taxpayer service needs and preferences of U.S. taxpayers abroad. Nonetheless, we note that WIRA needs to be able to accurately identify distinct subsegments of the international U.S. taxpayer population. If it bases its efforts on broad categorizations of the population, its research results will be of limited value in ascertaining specific service needs.

The IRS comments confirm the lack of a coordinated service strategy for international taxpayers. The IRS does not present a clear picture of how it plans to improve service-wide coordination of services for these taxpayers. As discussed in the TAS comments on specific most serious problems dealing with international issues, current IRS efforts and service programs are sporadic and not coordinated.<sup>33</sup> The National Taxpayer Advocate is concerned that in the absence of a servicewide forum for international taxpayer service, the IRS will be unable to properly evaluate needs and preferences of this taxpayer segment and take cost-effective steps to address them. The reasons cited by the IRS for the dissolution of the International Planning and Operations Council appear to be superficial, because it is within the IRS's power to adjust "the focus" and increase "the frequency" of council's meetings. Bilateral meetings, offered as a substitute for an open exchange of opinions at a servicewide forum, cannot achieve the goal of coordinating all taxpayer service and compliance activities. Moreover, bilateral meetings do not allow for a free and full discussion of the problems facing international taxpayers, by which all interested and impacted IRS functions can hear each other's perspective. The National Taxpayer Advocate is also unaware of any servicewide effort by the Deputy Commissioner, International to coordinate service for U.S. taxpayers abroad. Moreover, to date, the IRS has not offered bilateral meetings to TAS or invited the National Taxpayer Advocate to participate in the International Executive team meetings. While we appreciate the commitment of the IRS to "consider the views included in the National Taxpayer Advocate's report," periodic meetings would assist the IRS in doing so and ensure that related problems can also be identified and resolved.

With respect to the Forum on Tax Administration, the National Taxpayer Advocate appreciates the availability of the IRS delegate and is looking forward to establishing periodic meetings for sharing and obtaining suggestions and ideas about best practices in service delivery around the world.

<sup>33</sup> See TAS comments to Most Serious Problems: *Individual U.S. Taxpayers Working, Living, or Doing Business Abroad Need Expanded Service Targeting Their Specific Needs and Preferences*; *Small Businesses Involved in International Economic Activity Need Targeted IRS Assistance*; *Foreign Taxpayers Face Challenges in Fulfilling U.S. Tax Obligations*, *supra*; *U.S. Taxpayers Abroad Face Challenges With Understanding How the IRS Will Apply Penalties to Taxpayers Who Are Reasonably Trying to Comply or Return Into Compliance*, *infra*.

Finally, the National Taxpayer Advocate disagrees with the IRS's assessment that "educating taxpayers abroad, resolving their compliance issues, and identifying systemic issues facing international taxpayers can[not] be adequately addressed by placing single individuals in overseas offices." Today, international taxpayers lack access to face-to-face assistance from taxpayer advocates. Although we agree that "establish[ing] LTA positions in each of the four existing tax attaché offices abroad will not afford every taxpayer an opportunity to avail him or herself of Taxpayer Advocate services," the National Taxpayer Advocate believes it would give international taxpayers the opportunity to access advocacy services as needed. Not every taxpayer uses TAS services in the United States, but every taxpayer has the right and the opportunity to obtain face-to-face TAS assistance in every state. Establishing LTA positions at IRS offices abroad will enable underserved taxpayers to request an advocate's intervention in person and facilitate appropriate service to taxpayers in a specific country or area. LTAs at foreign posts also could travel to meet with taxpayers at other locations within their jurisdiction.

## Recommendations

The National Taxpayer Advocate recommends that the IRS:

1. Reinstate the International Planning and Operations Council as a servicewide forum devoted to international taxpayer service and enforcement.
2. 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.
3. Provide funding for TAS to establish Local Taxpayer Advocate positions in each of the four existing tax attaché offices abroad and include such positions in future expansion of attaché offices.

MSP  
#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****RESPONSIBLE OFFICIALS**

Faris Fink, Commissioner, Small Business/Self-Employed Division  
 Heather C. Maloy, Commissioner, Large Business and International Division  
 Frank Keith, Chief, Communications and Liaison  
 William J. Wilkins, Chief Counsel

**DEFINITION OF PROBLEM**

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 may 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.<sup>1</sup> The National Taxpayer Advocate is concerned about an apparent shift in the IRS's approach to the application of these civil penalties. Although the IRS's longstanding policy is to use penalties "to encourage voluntary compliance,"<sup>2</sup> there are indications the IRS may have used penalties as leverage against taxpayers who have entered into voluntary disclosure programs, often penalizing those who are trying to become compliant.<sup>3</sup>

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."<sup>4</sup> The Taxpayer Advocate Service (TAS) and the U.S. Ambassador to Canada have received similar complaints from Canadians who are confused and concerned about FBAR penalties.<sup>5</sup> In a letter to the New York Times, the

<sup>1</sup> Most international penalties are related to information returns and are civil penalties that are not based on the amount of underpayment, e.g., for failure to file information returns under 31 U.S.C. § 5321(a)(5) and IRC §§ 6038, 6038A, 6038B, 6038C, 6039F, 6046, 6046A, 6048. See also IRC §§ 6038D, 6662(b)(7). See also 31 U.S.C. § 5321(b)(1).

<sup>2</sup> See, e.g., H.R. Conf. Rep. No. 101-386 at 661 (1989) ("the IRS should develop a policy statement emphasizing that civil tax penalties exist for the purpose of encouraging voluntary compliance."); the IRS's 1998 Penalty Policy Statement acknowledged "the Service uses penalties to encourage voluntary compliance by ...helping taxpayers understand that compliant conduct is appropriate and that non-compliant conduct is not." See Policy Statement P-1-18 (Aug. 20, 1998), *superseded by* Policy Statement 20-1 (June 29, 2004). For an in-depth analysis of the civil tax penalty regime, see National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, at 1 (*A Framework for Reforming the Penalty Regime*).

<sup>3</sup> See Most Serious Problem: *The IRS's Offshore Voluntary Disclosure Program "Bait and Switch" May Undermine Trust in the IRS and Future Compliance Programs*, *infra*.

<sup>4</sup> See, e.g., American Citizens Abroad, *The FBAR Scam* (article submitted to Tax Notes International, Sept. 2011), at [http://www.aca.ch/joomla/index.php?option=com\\_content&task=view&id=488&Itemid=132](http://www.aca.ch/joomla/index.php?option=com_content&task=view&id=488&Itemid=132) (last visited Oct. 27, 2011). FBAR is the penalty for failure to file the required Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts* (FBAR). See 31 U.S.C. § 5321(a)(5); 31 C.F.R. § 1010.350.

<sup>5</sup> See, e.g., Barrie McKenna, *Ottawa seeks leniency for Canadians in U.S. tax hunt*, *The Globe and Mail* (Oct. 18, 2011) ("The U.S. ambassador, along with many federal MPs, have been flooded with calls and e-mails from Canadians worried they'll face punishing penalties..."); TAS Systemic Advocacy Management System (SAMS) Submissions No. 22023, 22133, 22134, 22173, 22195, 22203, 22393, 22433, 22497; for Calendar Year (CY) 2011, there were 48 international SAMS submissions (Dec. 20, 2011).

Washington Post, and the Wall Street Journal, the Canadian Finance Minister expressed concerns about the far-reaching implications of the Foreign Account Tax Compliance Act (FATCA) and the “nerve-racking” effect of FBAR reporting rules on hundreds of thousands of “honest and law-abiding” dual U.S. – Canadian citizens, including many seniors.<sup>6</sup> Many appear to be under the impression that 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 taxpayers 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.<sup>7</sup>

## ANALYSIS OF PROBLEM

### Background

The law requires international taxpayers to file a number of information returns and imposes severe civil penalties for failing to file, many of which are not based on the amount of the underpayment of tax.<sup>8</sup> Among the most publicized are the penalties for failure to disclose foreign financial accounts (FBAR) and foreign financial assets (FATCA).

A taxpayer may be subject to a civil FBAR penalty of up to \$10,000 per violation for failing to report foreign financial accounts on Form TD F 90–22.1, *Report of Foreign Bank and Financial Accounts*, even if the failure was not “willful.”<sup>9</sup> If the government establishes the failure was willful, the maximum penalty is the greater of \$100,000 or 50 percent of the

<sup>6</sup> See, e.g., Financial Post (Canada), *Read Jim Flaherty's letter on Americans in Canada* (Sept. 16, 2011); MSN Money, *Canada Tells IRS to Back Off* (Sept. 20, 2011). The letter was reprinted in a number of Canadian and U.S. newspapers.

<sup>7</sup> While an estimated five million to seven million U.S. citizens reside abroad, the IRS received only 218,840 FBAR filings in 2008. IRS website, *Reaching Out to Americans Abroad* (Apr. 2009), <http://www.irs.gov/businesses/article/0,,id=205889,00.html>; W&I Research Study Report, *Understanding the International Taxpayer Experience: Service Awareness, Use, Preferences, and Filing Behaviors* (Feb. 2010) (citing U.S. Department of State data). This number does not include U.S. troops stationed abroad. See also National Taxpayer Advocate, 2009 Annual Report to Congress 144 (Most Serious Problem: *U.S. Taxpayers Located or Conducting Business Abroad Face Compliance Challenges*).

<sup>8</sup> For a list of international information return penalties 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*, *supra*. These penalties include but are not limited to penalties under IRC §§ 6038, 6038A, 6038B, 6038C, 6039F, 6046, 6046A, 6048. See also IRC §§ 6038D, 6662(b)(7); 31 U.S.C. § 5321(a)(5).

<sup>9</sup> See 31 U.S.C. § 5321(a)(5)(B); 31 C.F.R. § 1010.350. Prior to October 22, 2004, there was no penalty for a non-willful failure to file and the maximum civil penalty for willful violations was \$100,000. The American Jobs Creation Act of 2004, Pub. L. No. 108-357, Title VIII, § 821(a), 118 Stat. 1586 (Oct. 22, 2004) established a penalty for non-willful violations and increased the penalty for willful violations.

balance of the undisclosed account annually.<sup>10</sup> The taxpayer may also face criminal penalties of up to \$500,000 and ten years in prison.<sup>11</sup>

For taxable years beginning after March 18, 2010, an additional penalty regime for financial asset reporting applies, and appears to overlap significantly with the disclosure requirements of the FBAR. The Foreign Account Tax Compliance Act, enacted in 2010 as part of the Hiring Incentives to Restore Employment (HIRE) Act, imposes a penalty of \$10,000 (and of up to \$50,000 for continued failure after IRS notification) on U.S. taxpayers holding financial assets outside the United States who failed to report those assets to the IRS on the new Form 8938, *Statement of Specified Foreign Financial Assets*.<sup>12</sup> Further, underpayments of tax attributable to non-disclosed foreign financial assets are subject to an additional substantial understatement penalty of 40 percent.<sup>13</sup> The IRS has suspended information reporting requirements until it releases the final version of Form 8938.<sup>14</sup>

#### **Strict Application of Overlapping Penalties May Reduce Rather Than Improve Voluntary Compliance.**

U.S. taxpayers abroad are concerned about overlapping and stacking penalties that cover the same conduct and are disproportionate to the tax liability at issue. For example, a dual U.S.-Canadian citizen living in Canada would not generally have a U.S. tax liability after application of the foreign earned income exclusion (FEIE) and foreign tax credit (FTC). However, he or she still may be liable for the FBAR penalty for failing to report a financial interest in or signature authority over a foreign financial account exceeding \$10,000, and for the FATCA penalty for failure to report foreign assets in excess of \$50,000. Therefore, a taxpayer who fails to report \$50,000 of savings in a Canadian bank account could be liable for both penalties of \$20,000 for a non-willful violation and up to \$160,000 for a willful failure annually. Strict application of both penalties can penalize taxpayers who are reasonably trying to return into compliance, which may reduce rather than improve voluntary compliance.

<sup>10</sup> 31 U.S.C. § 5321(a)(5)(C). The penalty can reach 300 percent of the account balance if the willful failures continue over a six-year period. A six-year statute of limitations applies to the civil FBAR penalty. See 31 U.S.C. § 5321(b)(1).

<sup>11</sup> 31 U.S.C. §§ 5321(a)(5)(C) and 5322; 31 C.F.R. § 1010.840(b). To establish willfulness for either civil or criminal penalties, the IRS generally has to establish that the taxpayer had knowledge of the FBAR filing requirement. See generally CCA 200603026 (Sept. 1, 2005) (suggesting “there is no willfulness if the account holder has no knowledge of the duty to file the FBAR”). It is unclear to what extent answers to questions on Form 1040, Schedule B, regarding the taxpayer’s signature authority over foreign accounts establish willfulness. Compare *U.S. v. Sturman*, 951 F.2d 1466 (6th Cir. 1991) (suggesting that the failure to answer the questions on Form 1040, Schedule B, regarding signature authority over foreign accounts may create an inference that the failure to file an FBAR was willful), with *U.S. v. Williams*, 2010-2 USTC ¶ 50,623 (E.D. Va. 2010) (concluding that an individual who indicated on Form 1040, Schedule B, that he did not have signature authority over foreign accounts did not willfully fail to file the FBAR because he reasonably believed the IRS already knew about the accounts).

<sup>12</sup> The Foreign Account Tax Compliance Act, enacted in 2010 as part of the Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, 124 Stat. 71 (Mar. 18, 2010), added new IRC § 6038D, *Information With Respect to Foreign Financial Assets*. FATCA also applies to foreign financial institutions (FFIs) that are required to report to the IRS certain information about financial accounts held by U.S. taxpayers, or by foreign entities in which U.S. taxpayers hold a substantial ownership interest. *Id.* (codified as IRC §§ 1471-1474).

<sup>13</sup> See generally IRC §§ 6038D and 6662(b)(7).

<sup>14</sup> Notice 2011-55, 2011-29 I.R.B. 53.

We acknowledge that many international information reporting penalties, and FBAR and FATCA in particular, were designed to fight offshore tax evasion by “bad actors” whose sole or primary reason for establishing and maintaining unreported overseas accounts was to hide income and avoid paying U.S. taxes they legally owe.<sup>15</sup> By contrast, there are relatively “benign actors” whose primary reasons for establishing and maintaining overseas accounts are unrelated to tax, and those who would have at most a *de minimis* tax liability after application of the foreign earned income exclusion, foreign housing exemption or deduction, and foreign tax credit.<sup>16</sup> Examples of these “benign actors” given by tax practitioners include:

- Residents of Canada or other foreign countries who were born in the U.S. while their parents were vacationing or temporarily working here and have dual citizenship, but have never lived or filed tax returns in the U.S.;
- People who inherited an overseas account or opened one to send money to friends or relatives abroad;<sup>17</sup>
- Refugees from Iran when the Shah fell, or immigrants from other totalitarian countries who felt compelled to conceal their assets in offshore accounts out of concern that the governments they fled might pursue them; and
- Holocaust survivors and their children who are frightened that persecution based on national origin could happen again and feel safer spreading their assets around in case they are seized in one place or another.

According to the IRS policy statement, “[p]enalties are used to enhance voluntary compliance.... [T]he Service will design, administer, and evaluate penalty programs based on how those programs can most efficiently encourage voluntary compliance.”<sup>18</sup> As the “penalty handbook” explains, “[p]enalties best aid voluntary compliance if they support belief in the fairness and effectiveness of the tax system.”<sup>19</sup> It acknowledges that disproportionately large or seemingly unfair penalties or “[a] wrong [penalty] decision, even though eventually corrected, ha[ve] a negative impact on voluntary compliance.”<sup>20</sup>

<sup>15</sup> See Joint Committee on Taxation, JCS-2-11, *General Explanation of Tax Legislation Enacted in the 111th Cong.* 193-219; 223-232 (Mar. 2011); Joint Committee on Taxation, JCS-5-05, *General Explanation of Tax Legislation Enacted in the 108th Cong.* 377-378 (May 2005). See also Statement of Senator Levin on HIRE Act, H.R. 2847, 111th Cong. 2d Sess., 156 Cong. Rec. S1745-01 (Mar. 18, 2010); Joint Committee on Taxation, JCX-42-09, *Technical Explanation of the “Foreign Account Tax Compliance Act of 2009”* (Oct. 27, 2009).

<sup>16</sup> For TY 2009, 88 percent of all taxpayers claiming the foreign earned income exclusion did not have U.S. tax liability after applying the exclusion. After the application of the foreign tax credit, only about nine percent of these taxpayers had a U.S. tax liability. See Most Serious Problem: *Individual U.S. Taxpayers Working, Living, or Doing Business Abroad Require Expanded Service Targeting Their Specific Needs and Preferences*, *supra*.

<sup>17</sup> We recognize a special five-percent rate may apply to some of these taxpayers, but believe that exception is too narrow to apply in some sympathetic cases. OVDI FAQ #52.

<sup>18</sup> Policy Statement 20-1 (June 29, 2004).

<sup>19</sup> IRM 20.1.1.2(10) (Dec. 11, 2009).

<sup>20</sup> IRM 20.1.1.1.3 (4)(C) (Dec. 11, 2009). See also IRM 4.26.16.4 (July 1, 2008) (noting that the penalties for failure to file the required Report of Foreign Bank and Financial Accounts (FBAR) “should be asserted only to promote compliance with the FBAR.... In exercising their discretion, examiners should consider whether the issuance of a warning letter and the securing of delinquent FBARs, rather than the assertion of a penalty, will achieve the desired result of improving compliance in the future.... Discretion is necessary because the total amount of penalties that can be applied under the statute can greatly exceed an amount that would be appropriate in view of the violation.”).

### **The Potential for Strict Application of FBAR and Other Penalties Causes Unnecessary Stress and Fear Among Benign Actors Who Made Honest Mistakes.**

Now that both the Offshore Voluntary Disclosure Program (OVDP) and the subsequent 2011 Offshore Voluntary Disclosure Initiative (OVDI) are closed to new applicants, benign actors who have failed to file FBARs are confused about what they should do.<sup>21</sup> As noted earlier, some of these taxpayers have complained to TAS and the U.S. Ambassador to Canada.<sup>22</sup> Many seem to believe the IRS will always seek the maximum FBAR penalty for willful violations, regardless of the situation, even outside of the OVDP and OVDI.

The IRS has been using threatening language about how it may impose severe penalties against anyone who did not apply to the OVDP and OVDI. For example, recent IRS statements include:

Those taxpayers making ‘quiet’ disclosures should be aware of the risk of being examined and potentially criminally prosecuted for all applicable years.<sup>23</sup>

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Taxpayers who do not submit a voluntary disclosure run the risk of detection by the IRS and the imposition of substantial penalties, including the fraud penalty and foreign information return penalties, and an increased risk of criminal prosecution.<sup>24</sup>

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Failing to file an FBAR subjects a person to a prison term of up to ten years and criminal penalties of up to \$500,000.<sup>25</sup>

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[For those who opt out of the OVDP] All relevant years and issues will be subject to a complete examination. At the conclusion of the examination, all applicable penalties (including information return and FBAR penalties) will be imposed. Those penalties could be substantially greater than the 20 percent penalty.<sup>26</sup>

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<sup>21</sup> See, e.g., Letter from American Citizens Abroad to the Commissioner, IRS, National Taxpayer Advocate, and Secretary of the Treasury, *American Citizens Abroad (ACA) Response to FBAR Penalties Imposed on Americans Residing Overseas* (Nov. 1, 2011). For a discussion of recent problems with the IRS's offshore voluntary compliance program, see Most Serious Problem: *The IRS's Offshore Voluntary Disclosure Program "Bait And Switch" May Undermine Trust in the IRS and Future Compliance Programs*, *infra*.

<sup>22</sup> See, e.g., Barrie McKenna, *Ottawa seeks leniency for Canadians in U.S. tax hunt*, *The Globe and Mail* (Oct. 18, 2011) ("The U.S. ambassador, along with many federal MPs, have been flooded with calls and e-mails from Canadians worried they'll face punishing penalties...").

<sup>23</sup> OVDP FAQ #10.

<sup>24</sup> OVDP FAQ #3.

<sup>25</sup> OVDP FAQ #14.

<sup>26</sup> OVDP FAQ #34.

[Q] Is the IRS really going to prosecute someone who filed an amended return and correctly reported all their income? ... [A] When criminal behavior is evident and the disclosure does not meet the requirements of a voluntary disclosure under IRM 9.5.11.9, the IRS may recommend criminal prosecution to the Department of Justice.<sup>27</sup>

This “tough talk” has created confusion and consternation, particularly among U.S. citizens abroad, and has resulted in a flood of media coverage and multiple entries on TAS’s Systemic Advocacy Management System.<sup>28</sup> Some comments are reproduced below:

I am fairly typical of dual citizens living outside the U.S. since 1980. I’ve been trying now for over a year to become compliant, not having realized like almost everyone here that I needed to file FBARs for past years. I have to pay someone at least a couple thousand francs to do it for me, even though I have not owed any U.S. taxes for years and have always filed and paid Swiss taxes. This is simply sick, and for a family that struggles financially. I see no reason at all to remain an American. There is a moral dilemma here.<sup>29</sup>

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I am an average American-born citizen who married a Dane and moved to Denmark. I was unaware that I was supposed to file a form telling the IRS of a bank account I opened here in Denmark to deposit my meager income from my Danish employer. Not only am I to report my bank account but also all other accounts, including pension and retirement accounts. I was hunted down by the IRS and harassed for living overseas but not claiming a foreign bank account. It’s become overwhelming and intrusive. I am now considering giving up my U.S. citizenship as I can honestly say that this abuse of the IRS and government power is not what America is supposed to be about. These regulations have now lost all sense of logic and reason and have been used to harass average citizens living and working abroad trying to make a simple living. It’s becoming abusive.<sup>30</sup>

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<sup>27</sup> OVDP FAQ #49.

<sup>28</sup> Westlaw search of U.S. and foreign media reveals more than a hundred publications regarding the confusion of U.S. taxpayers abroad and concerns about unfair application of penalties (Search conducted on Oct. 28, 2011). See, e.g., MSN Money, *Canada Tells IRS to Back Off* (Sept. 20, 2011) (“Tax crackdown could ensnare tens of thousands of innocent US citizens, and our neighbor to the north is having none of it.”); Financial Post (Canada), *Americans in Canada: Tax Confusion Reigns* (Sept. 19, 2011) (The article also has dozens of comments on Facebook (last visited Oct. 29, 2011). The number of SAMS submissions involving international issues increased more than threefold from calendar year (CY) 2008 to CY 2011, with a spike of 48 submissions in CY 2011 (through Oct. 25, 2011). See Most Serious Problem: *Globalization Requires Greater Internal IRS Coordination of International Taxpayer Service*, *supra*.

<sup>29</sup> American Citizens Abroad, *The FBAR Scam 5* (article submitted to Tax Notes International, Sept. 2011), at [http://www.aca.ch/joomla/index.php?option=com\\_content&task=view&id=488&Itemid=132](http://www.aca.ch/joomla/index.php?option=com_content&task=view&id=488&Itemid=132) (last visited Oct. 27, 2011) (a testimonial from an American in Switzerland).

<sup>30</sup> *Id.*

I was born in Canada; my mother is from the United States. When I was born, my mother applied for me to get dual citizenship, and I received a certificate of birth abroad. I am now 30 years old and just now discovering that it is required for me to have been filing tax returns in the U.S., even though I wasn't born and have never lived in the U.S. As a Canadian there was no clear way for me to be aware of this. There has been no attempt by the IRS to contact me to notify me that I haven't filed and am past due. I am now stuck trying to figure out how, and how many years I need to file for. This is becoming a big deal to friends and family I know that live here in Canada. Being born and raised in Canada there is no way for me to have known about these requirements. I see this as a major problem as there may be penalties for me not having done so.<sup>31</sup>

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I was born in the U.S., but immigrated to Canada 43 years ago, married a Canadian and became a Canadian citizen five years later. Since then I have resided, worked and paid taxes in Canada, and never had any US source income or US assets of any kind. I never renewed my US passport and entered the US only for short family visits or vacations. I consider myself a Canadian. With no US income or assets, I had no reason to assume you needed to file US tax returns, and had never heard of FBAR reports. In 2010, my mother's US accountant, after completing her estate taxes, assured me I had no further personal filing obligations. At retirement age, I suddenly find out that the IRS claims I owe them \$70,000 for not annually filing a 1-page form reporting my "offshore" Canadian bank and investment accounts!! They threaten to take EVERYTHING if I resist their claims, but offer an "amnesty" if you come forward and file the FBARs. It holds out the prospect of reducing the penalty to zero, but in practice the IRS apparently always claims 5-25% of the money, including that of my Canadian husband since we converted to joint accounts in November, 2010 after I was re-diagnosed with lymphoma.<sup>32</sup>

The IRS's silence about what comes next and how benign actors may become compliant without paying disproportionate penalties has caused frustration in Canada, one of the closest allies of the United States, where hundreds of thousands of dual citizens live.<sup>33</sup>

<sup>31</sup> SAMS Submission No. 22433, *Lack of Information on Taxes for Dual Citizens* (data drawn on Oct. 11, 2011).

<sup>32</sup> SAMS Submission No. 22497, *FBAR Penalties Harm Canadian Dual Citizens* (data drawn on Oct. 11, 2011). Many U.S. citizens abroad disagree with the IRS's interpretation of the term "offshore," especially applied to their accounts and assets in high tax jurisdictions, such as Canada. While Black's Law Dictionary does not provide a definition of "offshore," free online resources and common sense explains it as "[l]ocated or based in a foreign country and not subject to tax laws." See, e.g., The Free Dictionary, at <http://www.thefreedictionary.com/offshore> (last visited Oct. 29, 2011). The IRS's website defines the term "offshore" as following: "[W]hen referring to a country, [offshore] means a jurisdiction that offers financial secrecy laws in an effort to attract investment from outside its borders. When referring to a financial institution, "offshore" refers to a financial institution that primarily offers its services to persons domiciled outside the jurisdiction of the country in which the financial institution is organized. IRS, *Abusive Offshore Tax Avoidance Schemes - Glossary of Offshore Terms*, <http://www.irs.gov/businesses/small/article/0,,id=106572,00.html> (last visited Oct. 29, 2011).

<sup>33</sup> See National Taxpayer Advocate, 2009 Annual Report to Congress 144 (Most Serious Problem: *U.S. Taxpayers Located or Conducting Business Abroad Face Compliance Challenges*). See also The Globe and Mail (Canada), *U.S. Tax Crackdown Hits Canadian Residents* (June 23, 2011) ("A tax crackdown by the United States has sent more than one million Americans and green-card holders living in Canada scrambling to figure out how to comply").

Canada's Finance Minister sent a letter to several major U.S. newspapers stating that the IRS is spreading "unnecessary stress and fear" among law-abiding Canadians in its aggressive pursuit of offshore tax cheats. The letter, *inter alia*, states:

The Americans are trying to target places in the world that house a lot of tax evaders, and that's not Canada... This is not a tax haven... Most of these Canadian citizens, many with only distant links to the United States, have a very limited knowledge of their reporting obligations to the United States... These are honest and law-abiding people, including senior citizens now caught up in a nerve-wracking situation. Because they work and pay taxes in Canada, they generally do not owe any taxes in the United States. ... They are not high rollers with offshore bank accounts. These are people who have made innocent errors of omission that deserve to be looked upon with leniency.<sup>34</sup>

Increasing the danger that taxpayers who have reasonably and in good faith tried to comply will nonetheless be penalized may achieve an opposite result: that the IRS or the tax rules will be perceived as unfair, and voluntary compliance will suffer.<sup>35</sup>

### **Benign Actors Need Clear Guidance on How to Avoid FBAR, FATCA, and Other Penalties if They Are Reasonably Trying to Comply or Return into Compliance.**

Most if not all penalty provisions applicable to international taxpayers, including FATCA and FBAR, contain a reasonable cause exception and give the IRS a broad authority to issue regulations and guidance.<sup>36</sup> For example, the FBAR statute specifies only a "maximum" penalty that the IRS "may" impose; it does not *require* the IRS to apply the maximum penalty, or indeed any penalty, in every case.<sup>37</sup> It also provides for a reasonable cause exception without specifying what constitutes "reasonable cause." The Internal Revenue Manual (IRM) implements the statute by instructing employees to:

- Issue warning letters in lieu of penalties;
- Consider reasonable cause;
- Assert the penalty for willful violations only if the IRS has proven willfulness;
- Impose less than the maximum penalty for failure to report small accounts under "mitigation guidelines;" and
- Apply multiple FBAR penalties **only** in the most egregious cases.<sup>38</sup>

<sup>34</sup> See Financial Post (Canada), *Read Jim Flaherty's letter on Americans in Canada* (Sept. 16, 2011).

<sup>35</sup> One dual U.S. – Canadian citizen noted in regard to potential IRS actions after the expiration of the OVDI: "Can they come after me for more?...Nobody knows what they'll do." See The Globe and Mail (Canada), *Help! I'm on the IRS Hit List* (Sept. 20, 2011). See also Letter from American Citizens Abroad to the Commissioner, IRS, the National Taxpayer Advocate, and the Secretary of the Treasury, *American Citizens Abroad (ACA) Response to FBAR Penalties Imposed on Americans Residing Overseas* (Nov. 1, 2011).

<sup>36</sup> See, e.g., IRC §§ 6038D(g); 6038A(d)(3); 6038B(c)(2); 6039F(c)(2); 31 U.S.C. § 5321(a)(5)(B)(ii); (reasonable cause exception); IRC §§ 6038A(a); 6038B(a)(2); 6038D(h); 6039F(e) (authority to issue regulations).

<sup>37</sup> See generally 31 U.S.C. §§ 5314(a) and 5321(a)(5).

<sup>38</sup> IRM 4.26.16.4.4(2) (July 1, 2008) (reasonable cause); IRM 4.26.16.4.5.3 (July 1, 2008) ("The burden of establishing willfulness is on the Service."); IRM 4.26.16.4.7(3) (July 1, 2008) (warning letter in lieu of penalties); IRM Exhibit 4.26.16-2 (July 1, 2008) (mitigation guidelines); IRM 4.26.16.4.7 (July 1, 2008) ("the assertion of multiple [FBAR] penalties ... should be considered only in the most egregious cases.").

Yet the IRS has remained silent about the seemingly reasonable way in which the IRM suggests that it will apply FBAR penalties. To date, the IRS has not issued guidance about what constitutes “reasonable cause” for failure to file an FBAR. Although the IRS authorizes agents to issue a warning letter in lieu of an FBAR penalty, it provides them with little specific guidance, and no examples, about when such a letter is appropriate.<sup>39</sup> Thus, taxpayers who have reasonably tried to comply and have little or no tax liability may still be subject to the penalty. Most importantly, these “benign-actor” taxpayers have no clear sense that they will be treated differently from “bad-actor” taxpayers.

The IRS could allay these concerns by initiating a public guidance project, which incorporates comments from all internal and external stakeholders, and describes how it will administer FBAR and other penalties and its voluntary disclosure practice in the future.<sup>40</sup> The IRS’s current work on implementation of FATCA legislation makes this a good time to provide guidance to taxpayers and IRS employees by issuing a notice or similar public pronouncement that describes what benign actors should do, and emphasize that they will often not be subject to any penalties under existing statutes.<sup>41</sup> The IRS can improve compliance by increasing the fairness of the tax system instead of over-penalizing those who are trying to become compliant.

## CONCLUSION

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

1. The IRS should issue a notice or similar public pronouncement that:
  - a. Describes and reaffirms the taxpayer-favorable procedures regarding the application of the FBAR penalty provided by IRM 4.26.16;
  - b. Tells taxpayers what to do if they discover they have inadvertently failed to file FBARs; and

<sup>39</sup> IRM 4.26.16.4 (July 1, 2008) (noting that the penalties for failure to file the required FBAR “should be asserted only to promote compliance with the FBAR ... In exercising their discretion, examiners should consider whether the issuance of a warning letter and the securing of delinquent FBARs, rather than the assertion of a penalty, will achieve the desired result of improving compliance in the future ... Discretion is necessary because the total amount of penalties that can be applied under the statute can greatly exceed an amount that would be appropriate in view of the violation.”).

<sup>40</sup> This recommendation is consistent with recent comments from external stakeholders. See, e.g., Letter from New York State Bar Association Tax Section to Commissioner, IRS, Chief Counsel, IRS, and Acting Assistant Secretary (Tax Policy) Department of the Treasury, *2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers*, reprinted as, NYSBA Tax Section Comments on FAQ for 2011 Offshore Voluntary Disclosure Initiative, 2011 TNT 153-13 (Aug. 9, 2011) (recommending public guidance); Scott D. Michel and Mark E. Matthews, *OVDI Is Over – What’s Next for Voluntary Disclosures?*, 2011 TNT 201-3 (Oct. 7, 2011) (same); Letter from American Citizens Abroad to the Commissioner, IRS, the National Taxpayer Advocate, and the Secretary of the Treasury, *American Citizens Abroad (ACA) Response to FBAR Penalties Imposed on Americans Residing Overseas* (Nov. 1, 2011).

<sup>41</sup> See, e.g., Scott D. Michel and Mark E. Matthews, *OVDI Is Over – What’s Next for Voluntary Disclosures?*, 2011 TNT 201-3 (Oct. 7, 2011) (recommending, *inter alia*, not applying penalties to Americans living abroad absent fraud or willfulness, and a waiver of penalties in cases when there is no unreported income, or there is little or no tax due). The IRS is working on implementing FATCA and developing new reporting requirements to be incorporated in Treasury regulations expected to be issued in proposed form by the end of 2011. See IRS Notices 2011-55, 2011-29 I.R.B. 53; 2011-53, 2011-32 I.R.B. 124; 2011-34, 2011-19 I.R.B. 765; 2010-60, 2010-37 I.R.B. 329.

- c. Reassures them that they are most likely to receive a warning letter if they follow the instructions in the notice.<sup>42</sup>
2. As part of the FATCA implementation project, develop specific guidance to clarify how taxpayers who have reasonably tried to comply with international information reporting requirements can avoid multiple penalties for the same conduct.

## IRS COMMENTS

The IRS seeks to fairly administer its penalty regimes. It is not the case, as stated in the National Taxpayer Advocate's report, that there has been a shift in the IRS's approach to the application of civil penalties. The IRS does recognize that there has been confusion and inaccurate assertions regarding the IRS' application of penalties. The IRS recently published an informational fact sheet illustrating how present law penalties operate.<sup>43</sup>

As stated in the recently-issued IRS fact sheet and in news release IR-2008-79 (June 17, 2008), the IRS will not assert FBAR penalties if IRS determines the violations were due to reasonable cause and the delinquent FBARs are filed. The IRS is sensitive to the unusual nature of the FBAR penalty when compared to Title 26 penalties and additions to tax. While Title 26 penalties and additions to tax are generally defined at a set rate (*e.g.*, five percent, 0.5 percent per month, 20 percent of the underpayment, etc.), Congress has defined the FBAR penalty in terms of maximum or "up to" amounts. This can create the impression that examiners assert the FBAR penalty only at the maximum rate. This is not the case. Guidelines exist to ensure that excessive penalties are not asserted. The IRM advises examiners to propose penalties only up to amounts necessary to insure future compliance. Additional guidance is provided on mitigation of the penalty — even down to zero — if circumstances warrant it.<sup>44</sup> Further restraint is provided by requiring that the Office of Chief Counsel provide input upon all FBAR penalties proposed. Additionally, the IRS Appeals Division provides a pre-assessment appeals conference when the taxpayer files a timely protest to the penalty proposal. In short, measures are in place to prevent taxpayers from being subjected to financially devastating penalties.

While the penalties for failing to file foreign information returns (*e.g.*, Forms 8938, 5471, 3520, 3520-A, etc.) do not contain mitigating guidelines to allow examiners to depart downward from the penalty rate, all penalties for failing to file foreign information returns can be abated in full if the failure to file was due to reasonable cause and not willful neglect.<sup>45</sup>

<sup>42</sup> On October 26, 2011, the National Taxpayer Advocate issued a memorandum to the Commissioner of Internal Revenue underlining some of these recommendations, which are also discussed in the Most Serious Problem: *The IRS's Offshore Voluntary Disclosure Program "Bait and Switch" May Undermine Trust in the IRS and Future Compliance Programs*, *infra*. See Memorandum for Douglas Shulman, Commissioner of Internal Revenue, from Nina E. Olson, National Taxpayer Advocate, Recommendations Regarding Taxpayer Advocate Directive 2011-1 (Oct. 26, 2011), *infra*, at 229.

<sup>43</sup> See *Information for U.S. Citizens or Dual Citizens Residing Outside the U.S.*, <http://www.irs.gov/newsroom/article/0,,id=250788,00.html>.

<sup>44</sup> IRM 4.26.16.

<sup>45</sup> IRM 20.1.9.1.1 states that reasonable cause applies to most, but not all, of the penalties. Reasonable cause will be considered by the examiner per IRM 20.1.1, *Introduction and Penalty Relief*, prior to assessing the penalty.

IRS guidance to examiners on penalties is included throughout the IRM. All penalties are subject to reasonable cause or good faith exceptions, either as a matter of policy<sup>46</sup> or under the consolidated reasonable cause exception in IRC § 6664. In fact, IRM Exhibit 21.8.2-1 contains a Failure to File decision tree to assist examiners with reasonable cause determinations in the context of Form 5471. This resource can be used to determine reasonable cause exceptions for other penalties.

The IRM remains the primary source of guidance on penalties. IRM 4.26.16.4 includes general guidelines, non-willful penalty considerations, willful penalty considerations (definition, willful blindness, reasonable cause, evidence, *et al.*) and mitigation. IRM 20.1.1.3 provides a detailed discussion of reasonable cause under the title *Criteria for Relief from Penalties*.

The penalties set by Congress in Title 31 are maximum amounts before mitigation. Although the maximum non-willful and willful FBAR penalties are \$10,000 and 50 percent of the account balance as of the date of violation, respectively, examiners are free to determine whether the facts and circumstances of a particular case justify a penalty and if no penalty is appropriate, they should issue the FBAR warning letter.<sup>47</sup>

The IRS disagrees with the assertion in the report that we used penalties as leverage against taxpayers who have entered into voluntary disclosure programs. As discussed in our prior response, the 2009 OVDP was a voluntary program that taxpayers could choose to enter into. If at any time during the certification process, a taxpayer disagreed with the results provided for under the program (*e.g.*, if a taxpayer believed that a facts and circumstances determination would show that penalty mitigation is appropriate), the taxpayer could opt-out of the program and its penalty structure. This option is still available today.

With regard to the recommendations in the report, the IRS notes the following.

The IRS agrees that heightened public awareness regarding the FBAR penalty is critical to increasing FBAR reporting compliance. As discussed, the IRS recently published an informational fact sheet illustrating how present law penalties operate, including a reminder that FBAR penalties do not apply if the IRS determines that there is reasonable cause.<sup>48</sup>

We have also been taking other steps in this regard. The IRS's servicewide FBAR Communication Strategy Team, established in January 2011, leads a coordinated campaign to share consistent, accurate and easily-accessed FBAR information that helps filers comply with their filing obligations and, thereby, avoid the FBAR penalty.

<sup>46</sup> IRM 20.1.9.2 states the examiners must consider any reason a taxpayer provides in conjunction with the guidelines, principles, and evaluating factors relating to reasonable cause based on the facts and circumstances.

<sup>47</sup> IRM 4.26.16 Exhibit-2.

<sup>48</sup> See *Information for U.S. Citizens or Dual Citizens Residing Outside the U.S.*, <http://www.irs.gov/newsroom/article/0,,id=250788,00.html>.

IRS efforts during the past year included an October 2011 update to news release IR-2008-79, a June 2011 FBAR webinar, and the issuance of electronic reminders of the FBAR filing deadline of June 30. IR-2008-79 offers taxpayer-favorable guidance regarding FBARs that were inadvertently not filed and other helpful information about FBAR penalty application. The June 2011 webinar focused on FBAR reporting requirements following issuance of the Financial Crimes and Enforcement Network's final rule on FBAR responsibilities. The broadcast was available both domestically and abroad, and hosted over 2,300 participants. The IRS also used its Twitter account to issue FBAR filing deadline reminders and to provide IRS.gov web addresses identifying who was required to file.

The IRS will continue to share information with the public using IRS.gov and other communication vehicles designed to reach FBAR filers, both domestic and abroad.

With respect to the second recommendation to clarify how multiple penalties can be avoided for the same conduct, it is important to recognize that FBAR is required under Title 31 for other law enforcement purposes in addition to tax administration. As a consequence, different policy considerations apply to FBAR and other information reporting (e.g., Form 8938). These are reflected in the law defining differing categories of persons required to file Form 8938 and the FBAR, differing filing thresholds for Form 8938 and FBAR reporting, and differing assets (and accompanying information) required to be reported on each form. Although certain information may be reported on both Form 8938 and the FBAR, the information required by the forms is not identical in all cases. These differing policy considerations were recognized during the passage of the HIRE Act and the enactment of § 6038D, and the intention to retain FBAR reporting notwithstanding the enactment of § 6038D was specifically noted in the Technical Explanation Of The Revenue Provisions Contained In Senate Amendment 3310, The "Hiring Incentives To Restore Employment Act," Under Consideration by the Senate (Staff of the Joint Comm. on Taxation, JCX-4-10 (February 23, 2010)) (Technical Explanation) accompanying the HIRE Act. The Technical Explanation states that "[n]othing in this provision [section 511 of the HIRE Act enacting section 6038D] is intended as a substitute for compliance with the FBAR reporting requirements, which are unchanged by this provision." (Technical Explanation at p. 60).

The IRS is aware of overlap between FBAR and FATCA reporting in certain respects and, consequently, is cognizant of the potential for overlapping penalties for noncompliance under both regimes. To the extent that filers face overlapping reporting obligations under both FBAR and § 6038D, we note the presence under both reporting regimes of a reasonable cause exception to penalty application. As a result, noncompliant filers may well qualify for the reasonable cause exception to penalties under Title 31 for FBAR noncompliance and qualify for the reasonable cause exception to penalties under Title 26 for § 6038D noncompliance. The IRS will be sensitive to claims of reasonable cause in response to application of the § 6038D penalty.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased with the IRS's affirmation that all penalty considerations, including reasonable cause and mitigation guidelines for the FBAR penalty, continue to apply to the facts and circumstances of a particular case. Even though it took the IRS almost two months to publicize an FBAR fact sheet online, in response to a recommendation in her Taxpayer Advocate Directive and Memorandum to the Commissioner of Internal Revenue as well as multiple unfavorable press reports, it is a step in the right direction.<sup>49</sup>

The National Taxpayer Advocate generally supports the IRS's efforts to combat offshore tax evasion. However, such efforts should not create confusion or fear in the hearts of benign actors who made honest mistakes. Moreover, even efforts aimed at intentional tax evasion should conform to generally accepted concepts of due process, transparency, and procedural fairness.

For example, an estimated five to seven million U.S. citizens reside abroad, many of whom have FBAR filing requirements,<sup>50</sup> yet the IRS received only 218,840 FBARs in 2008.<sup>51</sup> These numbers leave little doubt that a large number of people still have not filed FBARs and many such violations are likely inadvertent.

As discussed in the Memorandum to the Commissioner, the National Taxpayer Advocate has recommended that the IRS clarify its seemingly inconsistent statements about what people should do if they learn they have inadvertently failed to file an FBAR. In an effort to encourage taxpayers to enter into the OVDP and OVDI, the IRS emphasized the severe FBAR penalties that could apply outside of these programs, suggesting that the more reasonable provisions of the still-current IRM might be obsolete, and that taxpayers making "quiet" corrections might be subject to stiffer penalties than in the past. TAS, organizations representing Americans overseas, and the U.S. Ambassador to Canada have been receiving complaints from people who inadvertently failed to file an FBAR and are confused and worried about how the IRS is administering FBAR penalties both inside and outside of the voluntary disclosure programs.<sup>52</sup>

<sup>49</sup> See IRS, *Information for U.S. Citizens or Dual Citizens Residing Outside the U.S.*, FS-2011-13 (Dec. 2011), at <http://www.irs.gov/newsroom/article/0,,id=250788,00.html>. See also Taxpayer Advocate Directive 2011-1 (*Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and Comply with the Freedom of Information Act*) (Aug. 16, 2011); Memorandum for Douglas Shulman, Commissioner of Internal Revenue, from Nina E. Olson, National Taxpayer Advocate, Recommendations Regarding Taxpayer Advocate Directive 2011-1 (Oct. 26, 2011), *infra*.

<sup>50</sup> IRS website, *Reaching Out to Americans Abroad* (Apr. 2009), <http://www.irs.gov/businesses/article/0,,id=205889,00.html>; W&I Research Study Report, *Understanding the International Taxpayer Experience: Service Awareness, Use, Preferences, and Filing Behaviors* (Feb. 2010) (citing U.S. Department of State data). This number does not include U.S. troops stationed abroad.

<sup>51</sup> National Taxpayer Advocate, 2009 Annual Report to Congress 144 (Most Serious Problem: *U.S. Taxpayers Located or Conducting Business Abroad Face Compliance Challenges*).

<sup>52</sup> See, e.g., Barrie McKenna, *Ottawa Seeks Leniency for Canadians in U.S. Tax Hunt*, *The Globe and Mail* (Oct. 18, 2011) ("The U.S. ambassador, along with many federal MPs, have been flooded with calls and e-mails from Canadians worried they'll face punishing penalties..."). For a sample of submissions to TAS's Systemic Advocacy Management System (SAMS) by Canadian residents, see the Memo to the Commissioner, *infra*. See also American Citizens Abroad (ACA), *The FBAR Scam*, [www.aca.ch/fbarscam.pdf](http://www.aca.ch/fbarscam.pdf) (last visited Nov. 16, 2011).

As the press continued to repeat the IRS's tough talk about how seemingly minor FBAR violations could trigger draconian penalties, and dual citizens tearfully described to reporters how the IRS was actually seeking such outrageous penalties, the IRS declined to comment.<sup>53</sup> Finally, in early December, as this document was en route to the printer, the IRS posted guidance on its website which suggested that it might still apply the reasonable provisions that appear in IRM 4.26.16 and the Penalty handbook, and issue additional guidance.<sup>54</sup>

While the IRS-released fact sheet is helpful, it has not been vetted in a manner similar to changes to the IRM or items published in the Internal Revenue Bulletin — and the IRS itself would be the first to point out that taxpayers generally cannot rely on fact sheets and press releases.<sup>55</sup> U.S. taxpayers abroad need formal guidance upon which they can rely.

Further, we note that this guidance was developed without any consultation with the National Taxpayer Advocate. Throughout this and other responses to the Most Serious Problems impacting international taxpayers, the IRS has referred to various “servicewide” teams or taskforces — yet the Taxpayer Advocate Service is not represented on these teams.<sup>56</sup> Congress placed the Office of the Taxpayer Advocate inside the IRS so that the IRS could benefit from the independent perspective of the statutory “voice of the taxpayer” before it implemented guidance. For over two years, in the arena of international tax administration, the IRS has failed to reach out to or heed that voice. The fearful climate we have today among “benign actor” international taxpayers demonstrates what can happen when it dismisses or ignores the National Taxpayer Advocate's concerns.

The IRS recognizes that FBAR and FATCA reporting obligations overlap in certain respects and, consequently, may result in overlapping penalties for the same conduct. The National Taxpayer Advocate appreciates the IRS's willingness to consider reasonable cause under both reporting regimes. While the IRS is diligently working on implementing FATCA guidance, it can address overlapping penalties and its position in regard to reasonable cause consideration under both regimes.

<sup>53</sup> See, e.g., Amy Feldman, *REFILE-Undisclosed Foreign Accounts? The IRS Is Coming*, Reuters (Nov. 9, 2011), <http://www.reuters.com/article/2011/11/09/offshoreaccounts-irs-idUSN1E7A80V920111109>; Amy Feldman, *Taxpayers with Overseas Accounts Seethe at Penalties*, Reuters (Dec. 8, 2011), <http://www.reuters.com/article/2011/12/08/us-usa-taxes-foreign-idUSTRE7B723920111208> (“One woman called from Australia on a Sunday night and started crying on the phone; another said she'd gotten psoriasis from the stress. A few were considering expatriating as soon as they could get their taxes in order ... The IRS had no comment for this story...”).

<sup>54</sup> See, e.g., IRS, *Information for U.S. Citizens or Dual Citizens Residing Outside the U.S.*, FS-2011-13 (Dec. 7, 2011); Kristen A. Parillo, *IRS to Minimize Penalties on Dual U.S.-Canadian Citizens Unaware of U.S. Tax Filing Obligations*, 2011 TNT 233-9 (Dec. 5, 2011); Marie Sapirie, *Reasonable Cause May Save Expats from Failure-to-File Penalties*, 2011 TNT 237-3 (Dec. 9, 2011).

<sup>55</sup> For example, the FBAR IRM does not contain an explanation of what constitutes reasonable cause for the purposes of Title 31. Instead, the IRS relies on IRM issued for Title 26 penalties for reasonable cause consideration under the FBAR statute. See, e.g., IRM 4.26.16; IRM 20.1.1.3.

<sup>56</sup> For example, in its response above, the IRS stated, “The IRS's servicewide FBAR Communication Strategy Team, established in January 2011, leads a coordinated campaign to share consistent, accurate and easily-accessed FBAR information that helps filers comply with their filing obligations and, thereby, avoid the FBAR penalty.” Despite calling the team “servicewide”, the Taxpayer Advocate Service is not represented on this team.

## Recommendations

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

1. Issue guidance in form of IRM changes or public guidance published in the Internal Revenue Bulletin that:
  - a. Describes, reaffirms, and expands the taxpayer-favorable procedures provided by IRM 4.26.16;
  - b. Tells people what to do if they discover they have inadvertently failed to file FBARs, reassuring them that they are most likely to receive a warning letter in accordance with the IRM if they follow the instructions provided by the guidance.<sup>57</sup>
2. As part of the FATCA implementation project, develop specific guidance to clarify how taxpayers who have reasonably tried to comply with international information reporting requirements can avoid multiple penalties for the same conduct.
3. 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.
4. Regularly consult with and provide briefings to the National Taxpayer Advocate on all matters pertaining to international information reporting requirements, penalties, and related compliance initiatives.

<sup>57</sup> This guidance should address the problems facing Canadians who learn they have failed to file FBARs. For further discussion, see Richard Lipton, *Fear and Loathing North of the Border*, 133 Tax Notes 1405 (Dec. 12, 2011).

MSP  
#12

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

### RESPONSIBLE OFFICIALS

Steven T. Miller, Deputy Commissioner, Services and Enforcement  
Heather C. Maloy, Commissioner, Large Business and International Division  
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Victor S.O. Song, Chief, Criminal Investigation  
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### DEFINITION OF PROBLEM

U.S. persons are generally required to report foreign accounts on Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts (FBAR)*, and to report income from such accounts on U.S. tax returns. The IRS "strongly encouraged" people who failed to file these and similar returns and report income from foreign accounts to participate in the 2009 Offshore Voluntary Disclosure Program (OVDP), rather than quietly filing amended returns and paying any taxes due.<sup>1</sup> It warned that taxpayers making "quiet" corrections could be "criminally prosecuted," while OVDP participants would generally be subject to a 20 percent "offshore" penalty in lieu of various other penalties, including FBAR.<sup>2</sup> The IRS announced, however, 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."<sup>3</sup> Taxpayers who would not have been subject to significant penalties because their violations were not willful or because they qualified for the "reasonable cause" exception believed this statement applied to them.

On March 1, 2011, more than a year after the 2009 OVDP ended, the IRS "clarified" its seemingly unambiguous statement. It would no longer consider whether taxpayers in the 2009 OVDP would pay less under existing statutes on the basis of non-willfulness or reasonable cause except in narrow circumstances. IRS leaders communicated the change in a memorandum that they did not disclose to the public, in violation of the Freedom of Information Act (FOIA), leaving IRS revenue agents (*i.e.*, auditors or examiners) to deliver the bad news to practitioners one at a time. This was, no doubt, particularly uncomfortable for agents who had agreed to settle on more favorable terms with a practitioner's other clients just the week before.

<sup>1</sup> See IRS, *Voluntary Disclosure: Questions and Answers*, <http://www.irs.gov/newsroom/article/0,,id=210027,00.html> (Feb. 9, 2011) (first posted May 6, 2009) (hereinafter "OVDP FAQ").

<sup>2</sup> OVDP FAQ #10.

<sup>3</sup> OVDP FAQ #35.

Taxpayers who believed they should pay less under existing statutes could either agree to pay more than they thought they owed or "opt out" of the 2009 OVDP and face the possibility of excessive civil penalties and criminal prosecution. Both options were problematic. Opting out would waste all of the resources already expended on the 2009 OVDP application by both the taxpayer and the IRS without bringing the taxpayer closure or certainty, as advertised. Moreover, in any future examination the IRS might have to request and review the items that were before the examiner processing the 2009 OVDP submission.<sup>4</sup>

The pressure that taxpayers who would pay less under existing statutes felt to remain in the program and pay more than they owed was even worse. It violated longstanding IRS policy along with most conceptions of fairness and due process.<sup>5</sup> The IRS's inconsistency and failure to follow its public guidance damaged its credibility with practitioners and could be subject to legal challenge. Moreover, all practitioners will now be obliged to advise clients who are considering participating in any future IRS settlement initiatives about how the IRS "clarified" this one. Thus, the IRS is likely to have much more difficulty gaining participation in any future settlement initiatives, as more people opt to "lie low" and make "quiet" corrections, if any.

## ANALYSIS OF PROBLEM

### Background

#### *What is an FBAR and why might someone fail to file it?*

U.S. persons are generally required to report foreign accounts on the FBAR form by June 30 of each year.<sup>6</sup> For various reasons, which often have nothing to do with taxes, many do not. For example, some people living abroad and using a local checking account are not aware they are required to file an FBAR.<sup>7</sup> Others living in the U.S. may simply inherit an overseas account or open one to send money to friends and relatives abroad while remaining oblivious to the FBAR filing requirement. Still others who have immigrated to the U.S. from repressive regimes may simply have an account containing "flee money," that they do not disclose to anyone (particularly a government) because they are holding it in case they are again persecuted by the government and need to flee.<sup>8</sup>

#### *The U.S. government has greatly increased FBAR-related penalties and enforcement.*

Perhaps because some people use offshore accounts for intentional tax evasion, money laundering, or terrorist financing, the U.S. government has greatly increased both

<sup>4</sup> This contradicted the portion of 2009 OVDP FAQ #35 that stated "[T]hese examiners [the OVDP examiners] will compare the 20 percent offshore penalty to the total penalties that would otherwise apply to a particular taxpayer."

<sup>5</sup> Policy Statement 4-7, *reprinted at* IRM 1.2.13.1.5 (Feb. 23, 1960).

<sup>6</sup> See, e.g., 31 U.S.C. § 5314; 31 C.F.R. § 1010.350(a); 31 C.F.R. § 1010.306(c).

<sup>7</sup> An FBAR is required if the aggregate value of the foreign accounts exceeds \$10,000. *Id.*

<sup>8</sup> See, e.g., Baker and McKenzie, *Undeclared Money Held Offshore: U.S. Voluntary Compliance Programs (Part 2)*, 21 J. Int'l. Tax'n 36, 44 (2010) (specifically describing four examples of persons stashing secret "flee money" in offshore accounts for nontax reasons after coming to the U.S. from Iraq, Indonesia, Mexico, or after having experienced the Holocaust).

FBAR-related penalties and FBAR enforcement in recent years.<sup>9</sup> Prior to October 22, 2004, there was no penalty for a non-willful failure to file and the maximum civil penalty for willful violations was capped at \$100,000.<sup>10</sup> Now, the maximum civil penalty is \$10,000 for each non-willful failure;<sup>11</sup> and if the government establishes the failure was willful, the maximum penalty is the greater of \$100,000 or 50 percent of the balance of the undisclosed account each year.<sup>12</sup> Thus, a person may be liable for FBAR penalties of 300 percent of the account balance for willful failures continuing over a six-year period.<sup>13</sup> Criminal penalties of up to \$500,000 and 10 years in prison may also apply.<sup>14</sup>

The Financial Crimes Enforcement Network (FinCen) delegated responsibility for FBAR enforcement to the IRS in April 2003.<sup>15</sup> Before then, the FBAR filing requirements were not well known, noncompliance was the norm, and the requirements were rarely enforced.<sup>16</sup> Consequently, even tax preparers sometimes failed to advise taxpayers about the FBAR filing requirement. The OVDP and the publicity surrounding it increased public awareness of the FBAR filing requirement. This publicity likely prompted many people whose failure to file FBARs was not willful to make voluntary disclosures.<sup>17</sup>

*Existing statutes, as implemented in the IRM, do not authorize the IRS to assert the maximum FBAR penalty in every case.*

Even before Congress increased FBAR penalties in 2004, the IRS published tiered penalty mitigation guidelines in the Internal Revenue Manual (IRM), directing examiners to apply less than the statutory maximums.<sup>18</sup> In 2008 the IRS updated these guidelines, explaining that the maximum FBAR penalty amounts can "greatly exceed an amount that would be appropriate in view of the violation."<sup>19</sup> It required examiners to apply even lesser penalties or a warning letter in lieu of penalties in many cases.<sup>20</sup> It explained that applying multiple

<sup>9</sup> See, e.g., Joint Committee on Taxation, JCS-5-05, *General Explanation of Tax Legislation Enacted in the 108th Cong.* 377-378 (May 2005).

<sup>10</sup> The American Jobs Creation Act of 2004, Pub. L. No. 108-357, Title VIII, § 821(a), 118 Stat. 1586 (Oct. 22, 2004) (amending 31 U.S.C. § 5321(a)(5)) established a penalty for non-willful violations, subject to a reasonable cause exception, and increased the penalty for willful violations.

<sup>11</sup> 31 U.S.C. § 5321(a)(5)(A)-(B).

<sup>12</sup> 31 U.S.C. § 5321(a)(5)(C).

<sup>13</sup> A six-year statute of limitations applies to the civil FBAR penalty. See 31 U.S.C. § 5321(b)(1).

<sup>14</sup> 31 U.S.C. §§ 5321(a)(5)(C) and 5322; 31 C.F.R. § 1010.840(b).

<sup>15</sup> See 68 Fed. Reg. 26,489 (May 16, 2003) (codified at 31 C.F.R. § 1010.810); IRM 4.26.16.1(2) (July 1, 2008) (same).

<sup>16</sup> A 2002 Treasury report estimated the FBAR compliance rate at less than 20 percent. U.S. Department of the Treasury, *A Report to Congress in Accordance with § 361(B) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001* 6 (Apr. 26, 2002). The government considered civil penalties in only 12 cases from 1993 to 2002. *Id.* at 8-10. Of those 12, only two taxpayers ultimately received penalties, four were issued "letters of warning," and the remaining six were not pursued. *Id.* Similarly, the U.S. Department of Justice filed just nine indictments related to FBAR violations, between 1996 and 1998, and none during 1999 and 2000. *Id.*

<sup>17</sup> The IRS received 15,364 applications to the 2009 OVDP. IRS response to TAS information request (Sept. 14, 2011). By comparison, it only received 1,326 applications to the 2003 Offshore Voluntary Compliance Initiative (OVCI), and (as of May 20, 2011) about 4,107 to the 2011 Offshore Voluntary Disclosure Initiative (OVDI), discussed below. IRS response to TAS information request (Sept. 14, 2011).

<sup>18</sup> See Memorandum for Acting Deputy Director, Compliance Field Operations, from Acting Deputy Director, Compliance Policy, SB/SE 2004-1, *Anti-Money Laundering Policy and Procedural Change Regarding Civil Examinations of the Reporting and Recordkeeping Requirements Respecting the Foreign Bank and Financial Accounts Report* (Apr. 15, 2004) (attachment 4).

<sup>19</sup> IRM 4.26.16.4(5) (July 1, 2008).

<sup>20</sup> *Id.*; IRM Exhibit 4.26.16-2 (July 1, 2008). As of this writing the July 1, 2008, IRM had not been updated or superseded.

FBAR penalties is to be "considered only in the most egregious cases."<sup>21</sup> Because the statute only specifies "maximum" FBAR penalty amounts that the IRS "may" impose, it would be inconsistent with the statute for the IRS to assert the maximum penalty amounts in every case.<sup>22</sup> Some have gone so far as to suggest that in the absence of these taxpayer-favorable IRM provisions, the FBAR penalties can be so disproportionate as to violate the Excessive Fines Clause of the Eighth Amendment to the U.S. Constitution.<sup>23</sup> Thus, examiners have long been required (under "existing statutes," as implemented by the IRM) to assert FBAR penalties of significantly less than the statutory maximums in all but the most egregious cases.

### HISTORIC VOLUNTARY DISCLOSURE PRACTICE

Pursuant to its longstanding voluntary disclosure practice, the IRS takes a voluntary disclosure into account in determining whether to refer a person for criminal prosecution.<sup>24</sup> To qualify, the person must (a) make a timely disclosure (*i.e.*, generally before the government begins an investigation or learns of the noncompliance), (b) cooperate with the IRS, and (c) arrange to pay the liability in full.<sup>25</sup> Historically, taxpayers who made a voluntary disclosure could often avoid civil penalties as well.<sup>26</sup> Some practitioners advised that if penalties did apply to a voluntary disclosure involving an offshore account, they would typically amount to 12 to 15 percent of the balance of the undisclosed account in question.<sup>27</sup> However, people could often achieve a similar result (*i.e.*, no criminal penalties and little or no civil penalties) by making a "quiet" disclosure – filing an amended return and paying any tax delinquency – without making a formal voluntary disclosure.<sup>28</sup>

<sup>21</sup> See, e.g., IRM 4.26.16.4.7 (July 1, 2008) ("If there was an FBAR violation but the examiner determines that a penalty is not appropriate, the examiner should issue the FBAR warning letter.... When a penalty is appropriate, IRS has established penalty mitigation guidelines to aid the examiner in applying penalties in a uniform manner.... Given the magnitude of the maximum penalties permitted for each violation, the assertion of multiple penalties and the assertion of separate penalties for multiple violations with respect to a single FBAR form, should be considered only in the most egregious cases."); IRM Exhibit 4.26.16-1 (July 1, 2008).

<sup>22</sup> 31 U.S.C. § 5321(a)(5).

<sup>23</sup> See Steven Toscher and Barbara Lubin, *When Penalties Are Excessive – The Excessive Fines Clause as a Limitation on the Imposition of the Willful FBAR Penalty*, J. Tax Practice & Procedure 69-74 (Jan. 2010).

<sup>24</sup> IRM 9.5.11.9 (Dec. 2, 2009). Technically, the IRS can still refer a taxpayer who makes a voluntary disclosure for criminal prosecution, but it must consider the disclosure in making that decision. *Id.*

<sup>25</sup> *Id.* The voluntary disclosure practice is not available to those with illegal-source income. *Id.*

<sup>26</sup> See, e.g., Mark E. Matthews and Scott D. Michel, *IRS's Voluntary Disclosure Program for Offshore Accounts: A Critical Assessment After One Year*, 181 DTR J-1, 4 (Sept. 21, 2010) (noting that before the OVD, "taxpayers rarely paid any penalties in connection with voluntary disclosures on offshore accounts. Indeed, most taxpayers, relying on the advice of skilled tax professionals, many of whom have decades of prior experience in the Justice Department or IRS, simply filed amended returns and paid the tax and interest. They were never audited. No penalties were ever asserted....").

<sup>27</sup> Baker and McKenzie, *Undeclared Money Held Offshore: U.S. Voluntary Compliance Programs (Part 2)*, 21 J. Int'l. Tax'n 36, 43 (2010).

<sup>28</sup> See, e.g., Mark E. Matthews and Scott D. Michel, *IRS's Voluntary Disclosure Program for Offshore Accounts: A Critical Assessment After One Year*, 181 DTR J-1 (Sept. 21, 2010); Baker and McKenzie, *Undeclared Money Held Offshore: U.S. Voluntary Compliance Programs (Part 2)*, 21 J. Int'l. Tax'n 36, 43 (2010) ("most practitioners generally recommended to their clients the use of informal or 'quiet' disclosure. In theory, the taxpayer ran the risk of being 'caught' but, in practice, the taxpayer rarely heard anything back from the Service or DOJ. Further, if one did participate in the formal voluntary disclosure process, most, if not all, penalties generally were abated").

### 2003 OFFSHORE VOLUNTARY COMPLIANCE INITIATIVE (OVCI)

Between January 14, 2003, and April 15, 2003, the IRS offered the Offshore Voluntary Compliance Initiative (OVCI) to persons using offshore payment cards or similar arrangements to improperly avoid paying taxes.<sup>29</sup> OVCI provided more certainty than the long-standing voluntary disclosure practice about what civil penalties would apply and when disclosures would be deemed timely in cases where the IRS was already actively pursuing the names of offshore credit card account holders (*e.g.*, accounts with UBS in Switzerland). Participants would have to pay six years of back taxes, interest, and certain accuracy and delinquency penalties, but would not face any civil fraud or information return penalties (including FBAR).<sup>30</sup>

### LAST CHANCE COMPLIANCE INITIATIVE (LCCI)

Between 2003 and 2009, the IRS issued letters to taxpayers specifically identified as holding an offshore payment card (or similar arrangement), offering them the so-called Last Chance Compliance Initiative (LCCI). Under the LCCI, the IRS would waive a number of penalties for failure to file information returns and, even if they otherwise applied to multiple years, would only impose the civil fraud and FBAR penalties for a single year.<sup>31</sup> Naturally, the IRS would not require people to pay more in FBAR penalties under LCCI than would be due under existing law and in most cases would accept less.<sup>32</sup> Examiners were expressly authorized to use discretion and apply FBAR mitigation guidelines to avoid inappropriately high FBAR penalties.<sup>33</sup>

### *The IRS has departed from its historic voluntary disclosure and settlement practices.*

The IRS apparently intended the 2009 Offshore Voluntary Disclosure Program (described below) to represent a significant departure from its historic practice of not requiring people to pay more inside an initiative than outside of it. Notwithstanding this intention, the unambiguous public terms of the 2009 OVDP were more consistent with its historic practice of attracting taxpayers to an initiative by offering a better deal than they would be likely to receive after an examination. Thus, taxpayers and practitioners felt the OVDP was a "bait and switch" when they learned the IRS changed the terms in mid-stream so that many taxpayers whose cases had not been processed by March 1, 2011, would be required to pay

<sup>29</sup> 2003 IR-2003-5 (Jan 14, 2003).

<sup>30</sup> See, *e.g.*, Rev. Proc. 2003-11, 2003-1 C.B. 311. A 2003 OVCI submission would also be treated as an application for the longstanding voluntary compliance practice, minimizing the risk of criminal prosecution. *Id.* The IRS received about 1,326 OVCI applications and the program resulted in collections of about \$225 million. Response to TAS information request (Sept. 14, 2011).

<sup>31</sup> See Notice 1341 (2007); Letter 3649 (2007); IRM 4.26.16.4.6.4 (July 1, 2008).

<sup>32</sup> See, *e.g.*, CCA 200603026 (Sept. 1, 2005) (noting: [the LCCI letter] "says, 'Also, civil penalties for violations involving [FBARs] will be imposed for only one year and we may resolve the FBAR penalty for less than the statutory amount based on the facts and circumstances of your case.' The instructions to agents contained in the Guidelines for Mitigation of the FBAR Civil Penalty for LCCI Cases provide: 'The examiner may determine that the facts and circumstances of a particular case may warrant that a penalty under these guidelines is not appropriate or that a lesser amount than the guidelines would otherwise provide is appropriate.' If agents follow these guidelines we need not be imposing the FBAR penalty arbitrarily in cases in which it clearly does not apply").

<sup>33</sup> See, *e.g.*, IRM Exhibit 4.26.16-4 (July 1, 2008) (LCCI penalty mitigation guidelines).

more inside the program than outside.<sup>34</sup> This reversal seemed even more unfair because many similarly situated taxpayers whose applications were processed before March 1 received a better deal than those whose applications were processed later.<sup>35</sup>

### 2009 OFFSHORE VOLUNTARY DISCLOSURE PROGRAM – THE “BAIT”

On March 23, 2009, the IRS ended the LCCI and issued a memo announcing the 2009 OVDP, which was similar to the LCCI.<sup>36</sup> As noted above, people whose noncompliance was non-willful or who qualified for the reasonable cause exception typically did not need to participate in a settlement initiative because in most cases, significant penalties would never have been on the table. In the case of the OVDP, however, the IRS “strongly” encouraged people who had unreported income to participate rather than quietly correcting any discrepancies by filing amended returns and paying any taxes due. IRS “frequently asked question” (FAQ) #10 states:

Taxpayers are **strongly encouraged** to come forward under the Voluntary Disclosure Practice.... Those taxpayers making “quiet” disclosures should be aware of the risk of being examined and potentially **criminally prosecuted for all applicable years**.... The IRS will be closely reviewing these returns to determine whether enforcement action is appropriate. [Emphasis added].<sup>37</sup>

Even so, taxpayers who had reasonable cause or whose failures were not willful would not want to participate if they would be subject to lower penalties outside of the program. They took comfort, however, in IRS guidance that indicated they would not have to pay more inside the program. Examiners were authorized to assess a single penalty (called the “offshore penalty”) equal to 20 percent of the amount in the foreign bank account in the year with the highest balance. This offshore penalty was “in lieu of all other penalties that may apply, including FBAR and information return penalties...” over a six-year period. Some practitioners reasoned that the offshore penalty would not apply “in lieu” of other penalties if the other penalties did not apply (*i.e.*, the taxpayer would not pay a 20 percent penalty under OVDP if under the existing statutes, he or she would be obligated to pay a

<sup>34</sup> See, e.g., Mark E. Matthews and Scott D. Michel, *IRS's Voluntary Disclosure Program for Offshore Accounts: A Critical Assessment After One Year*, 181 DTR J-1 (Sept. 21, 2010); Pedram Ben-Cohen, *IRS's Offshore Bait and Switch: The Case for FAQ 35*, 46 DTR J-1 (Mar. 9, 2011); CCH Federal Taxes Weekly, Practitioners' Corner: *Bar to Arguing Non-Willfulness Under Offshore Disclosure Programs Creates Concerns*, 2011 No. 13., 153, 155 (Mar. 31, 2011).

<sup>35</sup> TAS formally requested that the IRS provide: “The number of 2009 OVDP agreements accepted for less than the 20 percent offshore penalty on the basis that the violation was not willful or was subject to reasonable cause.” TAS request for IRS information (June 2, 2011). The IRS responded that this “number is not tracked and therefore cannot be determined.” IRS response to TAS information request (Sept. 14, 2011).

<sup>36</sup> Memorandum for Commissioner, Large and Mid-Size Business (LMSB) Division and Commissioner, Small Business/Self-Employed (SB/SE) Division from Deputy Commissioner for Services and Enforcement, *Authorization to Apply Penalty Framework to Voluntary Disclosure Requests Regarding Offshore Accounts and Entities* (Mar. 23, 2009); Memorandum for SB/SE Examination Area Directors and LMSB Industry Directors from Deputy Commissioner, *Emphasis on and Proper Development of Offshore Examination Cases, Managerial Review, and Revocation of Last Chance Compliance Initiative* (Mar. 23, 2009).

<sup>37</sup> In contrast to OVDP FAQ #9, which notes that those who did not underreport any income should not participate, OVDP FAQ #50 affirmatively advised “... the voluntary disclosure process is appropriate for most taxpayers who have underreported their income with respect to offshore accounts...” Notably, it did not carve out taxpayers whose unreported income was offset by a net operating loss or foreign tax credit resulting in little or no net tax liability or those who would be eligible for a penalty waiver or a reduced penalty under FBAR mitigation guidelines.

lesser penalty).<sup>38</sup> The IRS published key terms of the program as "frequently asked questions" (FAQs), which were more explicit.<sup>39</sup> On June 24, 2009, it added FAQ #35, which directly addressed the question of whether the IRS would agree to a penalty of less than 20 percent if a lower penalty would apply under existing statutes. It stated:

Q35. Will examiners have any discretion to settle cases? For example, if a penalty for failing to file a Form 5471 for 6 years is \$10,000 per year, will that be compared to 20 percent of the corporation's asset value? Would the lesser amount apply?

A35. **Voluntary disclosure examiners do not have discretion to settle cases for amounts less than what is properly due and owing. These examiners will compare the 20 percent offshore penalty to the total penalties that would otherwise apply to a particular taxpayer. Under no circumstances will a taxpayer be required to pay a penalty greater than what he would otherwise be liable for under existing statutes.** If the taxpayer disagrees with the IRS's determination, as set forth in the closing agreement, the taxpayer may request that the case be referred for a standard examination of all relevant years and issues. At the conclusion of this examination, all applicable penalties, including information return penalties and FBAR penalties, will be imposed. If, after the standard examination is concluded the case is closed unagreed, the taxpayer will have recourse to Appeals. See Q&A 34. [Emphasis added.]<sup>40</sup>

As discussed below, the IRS's subsequent reinterpretation of this language has generated significant controversy. While the 2009 OVDP ended on October 15, 2009, the IRS continued to process submissions throughout 2011.<sup>41</sup>

### 2011 OFFSHORE VOLUNTARY DISCLOSURE INITIATIVE (OVDI)

On February 8, 2011, the IRS announced the 2011 Offshore Voluntary Disclosure Initiative.<sup>42</sup> The terms were similar to those of the 2009 OVDP, except that the offshore penalty rate was 25 percent. In limited circumstances a special 5 percent or 12.5 percent

<sup>38</sup> See Baker and McKenzie, *Undeclared Money Held Offshore: U.S. Voluntary Compliance Programs* (Part 2), 21 J. Int'l. Tax'n 36, 39 (2010) ("The 20% penalty should be imposed only 'in lieu of all other penalties that may apply.' It should not, and cannot, be imposed if no such 'other penalties' apply, or if the 'other penalties that may apply' do not exceed 20% ...").

<sup>39</sup> See IRS, *Voluntary Disclosure: Questions and Answers*, <http://www.irs.gov/newsroom/article/0,,id=210027,00.html> (posted May 6, 2009) (adding FAQ #35 on June 24, 2009). For a discussion of the problem with issuing this guidance solely as an FAQ, see Most Serious Problem: *The IRS's Failure to Consistently Vet and Disclose its Procedures Harms Taxpayers, Deprives the IRS of Valuable Comments, and Violates the Law, infra*.

<sup>40</sup> The "discretion" language in the first sentence could be interpreted as clarifying that examiners would not have the authority traditionally delegated to Appeals officers to settle cases based on the "hazards of litigation." See, e.g., Policy Statement 8-47, *reprinted at*, IRM 1.2.17.1.6 (Aug. 28, 2007).

<sup>41</sup> See OVDP FAQ (preamble). According to IRS data, it received 15,364 applications to the 2009 OVDP and 6,577 remained open as of March 1, 2011. IRS response to TAS information request (Sept. 14, 2011).

<sup>42</sup> IRS, *2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers*, <http://www.irs.gov/businesses/international/article/0,,id=235699,00.html> (Aug. 29, 2011) (first posted Feb. 8, 2011) (hereinafter OVDI FAQ).

offshore penalty would apply.<sup>43</sup> In addition, instead of assuring taxpayers that a lower penalty would be used if applicable to a "particular taxpayer" under "existing statutes," in answer to the same question as OVDP FAQ #35, OVDI FAQ #50 provides, in relevant part:

A50: ...Under no circumstances will taxpayers be required to pay a penalty greater than what they would otherwise be liable for **under the maximum penalties imposed under existing statutes**.... Examiners will compare the amount due under this offshore initiative to the tax, interest, and applicable penalties (**at their maximum levels and without regard to issues relating to reasonable cause, willfulness, mitigation factors, or other circumstances that may reduce liability**) for all open years that a taxpayer would owe in the absence of the 2011 OVDI penalty regime. The taxpayer will pay the lesser amount. [Emphasis added].

This was a significant departure from the IRS's historic practice of not applying significant civil penalties to taxpayers making voluntary disclosures; the terms of the 2003 OVCI, which did not impose FBAR penalties; the terms of the LCCI, which allowed examiners to consider willfulness and the mitigation guidelines; and the express terms of the 2009 OVDP, which promised to require no more than "a particular taxpayer" would be liable for under "existing statutes."

We have been informed that the IRS meant to draft 2009 OVDP FAQ #35 in the way that it actually drafted 2011 OVDI FAQ #50.<sup>44</sup> While the IRS can obviously make one initiative more restrictive than another, it should not change the terms of a voluntary disclosure program or initiative after taxpayers have expended resources to apply for it in reliance on published terms that were more favorable.

#### THE MARCH 1, 2011 OVDP MEMO – THE "SWITCH"

On March 1, 2011, after IRS leaders learned that examiners were agreeing to penalties of less than the 20 percent offshore penalty based on OVDP FAQ #35, they issued an internal memo (the "March 1 memo") intended to extinguish what they perceived as an ambiguity.<sup>45</sup> Nonetheless, the March 1 memo provided that examiners could in fact continue to agree to

<sup>43</sup> See OVDI FAQ # 52; OVDI FAQ #53; Memorandum for Commissioner, Large Business and International (LB&I) Division and Commissioner, Small Business/Self-Employed (SB/SE) Division from Deputy Commissioner of Services and Enforcement, *Authorization to Apply Penalty Framework to Voluntary Disclosure Requests with Offshore Issues* (Mar. 1, 2011). The IRS also offered to amend 2009 OVDP settlements to provide these special rates to qualifying persons who had previously entered that program. *Id.*

<sup>44</sup> The IRS eventually began to inform the public of its intention. See Jeremiah Coder, *No Factual Determinations Made In Offshore Disclosure Initiative*, *IRS Official Says*, 2011 TNT 90-2 (May 10, 2011).

<sup>45</sup> Memorandum from Director, SB/SE Examination, and Director, International Individual Compliance, for all OVDI Examiners, *Use of Discretion on 2009 OVDP Cases* (Mar. 1, 2011). Issuing guidance in the form of an FAQ, which is subject to even less review than an interim guidance memorandum or IRM revision presents problems. Correcting it by issuing an undisclosed and unreviewed memo presents further difficulties. For a discussion of these issues, see *The IRS's Failure To Consistently Vet and Disclose Its Procedures Harms Taxpayers, Deprives It of Valuable Comments, and Violates the Law, infra*. The IRS eventually posted the March 1 memo in response to a Taxpayer Advocate Directive issued by the National Taxpayer Advocate on August 16, 2011. See Taxpayer Advocate Directive 2011-1 (Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and comply with the Freedom of Information Act), available at <http://www.irs.gov/advocate/article/0,,id=251887,00.html>. The March IRS memo is now available at [http://www.irs.gov/pub/irs-drop/ovdi\\_memo\\_use\\_of\\_discretion\\_3-1-11.pdf](http://www.irs.gov/pub/irs-drop/ovdi_memo_use_of_discretion_3-1-11.pdf).

penalties of less than 20 percent in some situations, such as where substantive "discussions concerning the assertion of an offshore penalty lower than 20 percent have taken place" with certain officials and were documented in the case file before Feb. 8, 2011 – the day the IRS announced the 2011 OVDI. Even so, the IRS had not processed closing agreements for 6,577 taxpayers who had applied for the 2009 OVDP, many of whom had applied in reliance on FAQ #35.<sup>46</sup>

In addition, a number of taxpayers who had discussions with examiners prior to February 8, 2011, concerning the assertion of an offshore penalty of less than 20 percent sought TAS's assistance because they had difficulty getting the IRS to apply a lesser penalty. Such difficulties may have resulted because IRS examiners sometimes asserted the discussions were undocumented or not "substantive," faced difficulty in getting approval from IRS technical advisors to apply a lesser offshore penalty, and were under pressure to close cases quickly either by agreement or by removing taxpayers from the program.

Even in cases where the IRS claimed to have done the comparison, its process for doing so seemed unfair to taxpayers. In order to avoid undertaking exam-like activities inside the OVDP "certification" process, the IRS simply assumed all violations were willful unless a taxpayer presented evidence to establish that a violation was not willful.<sup>47</sup> Even though participating taxpayers were obligated to cooperate, it did not bother to establish procedures for requesting evidence of reasonable cause or non-willfulness.<sup>48</sup> Moreover, it provided no guidance as to what evidence taxpayers could provide to establish non-willfulness or reasonable cause. Under existing statutes, however, the IRS could not impose the willful FBAR penalty unless it proved the violation was willful.<sup>49</sup> Thus, these procedures inverted the burden of proof.

When doing the comparison, the IRS also sometimes declined to apply some or all the taxpayer-favorable provisions contained in the IRM.<sup>50</sup> Consequently, a taxpayer would

<sup>46</sup> IRS response to TAS information request (Sept. 14, 2011). However, a number of taxpayers who believed they should pay less than 20 percent under the OVDP have requested assistance from TAS.

<sup>47</sup> IRS response to TAS information request (Aug. 4, 2011) ("In most cases, reasonable cause was not considered since examiners could not make that decision during a certification. Since OVDP cases were certifications and not examinations, it was up to the taxpayer to provide information to substantiate a lower penalty. In cases where clear and convincing documentation was provided by the taxpayer penalties at less than the maximum may have been considered at the discretion of the field subject to concurrence of a Technical Advisor .... Without adequate substantiation, maximum penalties were used for the comparison to the offshore penalty."). This critical aspect of the program was not included in the FAQs nor was it available to taxpayers or IRS employees in any written form. Moreover, it is contrary to the IRS's interpretation of the first sentence of FAQ #35 which states: "Voluntary disclosure examiners do not have discretion to settle cases for amounts less than what is properly due and owing."

<sup>48</sup> Although the IRS did not have a nationwide checklist of information that it would accept in determining what the penalty would be under existing statutes (e.g., whether the violation was willful), some revenue agents created their own checklists and routinely requested such information before the IRS issued the March 1 memo.

<sup>49</sup> *Ratzlaf v. United States*, 510 U.S. 135, 141 (1994); *U.S. v. Williams*, 2010-2 USTC ¶ 50,623 (E.D. VA. 2010); CCA 200603026 (Sept. 1, 2005); IRM 4.26.16.4.5.3 (July 1, 2008) ("The test for willfulness is whether there was a voluntary, intentional violation of a known legal duty. A finding of willfulness under the BSA must be supported by evidence of willfulness. The burden of establishing willfulness is on the Service.").

<sup>50</sup> IRM 4.26.16.4.4(2) (July 1, 2008) (reasonable cause exception); IRM 4.26.16.4.7(3) (July 1, 2008) (guidance on when to issue a warning letter in lieu of an FBAR penalty); IRM Exhibit 4.26.16-2 (July 1, 2008) (mitigation guidelines for applying lesser penalties to low-dollar accounts); IRM 4.26.16.4.7 (July 1, 2008) ("the assertion of multiple penalties ... should be considered only in the most egregious cases.").

often be required to pay more inside the program than he or she would "otherwise be liable for under existing statutes" outside of the program, even in cases where the IRS claimed to have done the comparison required by FAQ #35.

While it is reasonable to try to streamline the OVDP process, the IRS should have disclosed such significant aspects of the program.<sup>51</sup> The mere fact that the IRS referred to the process as a "certification" rather than an "examination" was not sufficient to put taxpayers on notice that it would make such significant deviations from existing statutes, as implemented by procedures described in the IRM.

### **The IRS's reinterpretation of FAQ #35 harms taxpayers and the IRS.**

*Taxpayers were concerned that withdrawal from the 2009 OVDP could subject them to the assertion of disproportionate civil and criminal penalties.*

Some taxpayers were initially concerned that opting out of the 2009 OVDP would disqualify them from the Criminal Investigation Division's longstanding voluntary disclosure practice on the basis that they would be deemed as not "cooperating," as required by the IRM.<sup>52</sup> In addition, the IRS's FAQs could have been interpreted as modifying the IRM's discussion of the voluntary disclosure practice for taxpayers with offshore accounts.<sup>53</sup> Various FAQs refer to the 2009 OVDP itself as the "voluntary disclosure practice," "Voluntary Disclosure Practice," or "voluntary disclosure program," and to participation in the 2009 OVDP as a "voluntary disclosure."<sup>54</sup> The FAQs suggest that people who do not use the 2009 OVDP might be prosecuted, even if they would otherwise have qualified for the voluntary disclosure practice.<sup>55</sup> Initially, the IRS did not provide clear and unequivocal assurance that if a taxpayer withdrew from the 2009 OVDP, he or she would not be deemed to have withdrawn from the voluntary disclosure practice, even if he or she would otherwise have been

<sup>51</sup> A former federal prosecutor involved in the UBS case apparently agrees. See Jeffrey A. Neiman, *Opting Out: The Solution for the Non-Willful OVDI Taxpayer*, 2011 TNT 176-6 (Sept. 7, 2011) ("While the IRS does not have unlimited resources, an expedited review process could have been established to compare the facts and circumstances of an individual taxpayer's overseas account to a set of predetermined objective factors that would have allowed the IRS to assess a reasonable and fair FBAR-related penalty and avoided higher penalties for non-willful taxpayers.").

<sup>52</sup> IRM 9.5.11.9 (Dec. 2, 2009). For example, according to one major firm, "three revenue agents have asserted that an 'opt out' would mean that the taxpayer had not cooperated and that the case would be returned to CI for further consideration of whether a criminal prosecution would be recommended." Baker and McKenzie, *Undeclared Money Held Offshore: U.S. Voluntary Compliance Programs (Part 2)*, 21 J. Int'l. Tax'n 36, 41 (2010). However, the IRM requires that the taxpayer cooperate "in determining his/her correct tax liability," rather than by agreeing to pay more in penalties than necessary. IRM 9.5.11.9(3)(a) (Dec. 2, 2009).

<sup>53</sup> IRM 9.5.11.9 (Dec. 2, 2009).

<sup>54</sup> See, e.g., OVDP FAQ#6 (suggesting that taxpayers should make a "voluntary disclosure" by either contacting CI or submitting a letter, which states that the submission is "[T]o assist in a timely determination of my acceptance into the Voluntary Disclosure Program"); FAQ #9 (referencing "the voluntary disclosure practice" and "the voluntary disclosure process" without making a distinction between them); FAQ #10 (strongly encouraging taxpayers to come forward under the "Voluntary Disclosure Practice"); FAQ #18 (noting: "The penalty framework described in the March 23 memorandum will apply to all voluntary disclosures in process within the 6-month timeframe"); FAQ #19 ("entities are eligible to participate in the IRS's Voluntary Disclosure Practice").

<sup>55</sup> See, e.g., FAQ #17 ("Taxpayers who wait until the end of the 6-month period run the risk that they will be disqualified from the Voluntary Disclosure Practice" and thus, will not have protection from criminal prosecution.).

eligible.<sup>56</sup> Moreover, 2009 OVDP FAQ #34 stated that "[A]ll relevant years and issues will be subject to a *complete examination ...[and] all applicable penalties (including information return and FBAR penalties) will be imposed*" [emphasis added] against those who opt out. This seemed to suggest that the IRS might seek criminal penalties against them, as well as the maximum civil penalties applicable to willful violations, without regard to the taxpayer-favorable provisions contained in the IRM.

*The IRS's use of memos and frequently-revised FAQs left taxpayers confused, and even more hesitant to opt-out.*

To its credit, on June 1, 2011, the IRS issued a memo that sought to allay taxpayer concerns about opting out. It sought to clarify that a "taxpayer should not be treated in a negative fashion merely because he or she chooses to opt out," and that opting out of the 2009 OVDP or 2011 OVDI would not remove the taxpayer from the criminal voluntary disclosure practice.<sup>57</sup> However, the memo was not very explicit about whether the IRS would apply the taxpayer-favorable provisions of the IRM to those who opted out. Further, according to the New York State Bar Association (NYSBA),

many revenue agents in the field have indicated that taxpayers who opt out of the voluntary disclosure programs will have a very difficult time convincing the Service not to impose maximum civil penalties. As a result, many taxpayers feel compelled to stay in the voluntary disclosure programs and accept inappropriately large penalties because they fear that if they opt out, they automatically will be assessed with huge information return penalties....<sup>58</sup>

Moreover, when viewed in context, this opt-out memo was merely one of a large number of items containing sometimes contradictory messages. Historically, settlement initiatives have been published in the Internal Revenue Bulletin.<sup>59</sup> However, the IRS described the OVDP and OVDI programs by posting informal FAQs and memos on its website. It posted or changed the terms of these programs 19 times, as follows:

<sup>56</sup> In answer to the question "[I]s the IRS really going to prosecute someone who filed an amended return and correctly reported all their [sic] income?," FAQ #49 provides no clear assurance, stating in relevant part: "When criminal behavior is evident and the disclosure does not meet the requirements of a voluntary disclosure under IRM 9.5.11.9, the IRS may recommend criminal prosecution to the Department of Justice." By contrast, 2011 OVDI FAQ #51 affirmatively stated that taxpayers who opt out of the 2011 OVDI "remain within Criminal Investigation's Voluntary Disclosure Practice."

<sup>57</sup> See Memorandum for Commissioner, LB&I Division and Commissioner, SB/SE Division, from Deputy Commissioner for Services and Enforcement, *Guidance for Opt Out and Removal of Taxpayers from the Civil Settlement Structure of the 2009 OVDP and the 2011 OVDI* (June 1, 2011); 2011 OVDI FAQ #51 (revised June 2, 2011).

<sup>58</sup> Letter from New York State Bar Association Tax Section to Commissioner, IRS, Chief Counsel, IRS, and Acting Assistant Secretary (Tax Policy) Department of the Treasury, *2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers*, reprinted as, *NYSBA Tax Section Comments on FAQ for 2011 Offshore Voluntary Disclosure Initiative*, 2011 TNT 153-13 (Aug. 9, 2011) (hereinafter "NYSBA Letter"). As noted above, according to one major firm, "three revenue agents have asserted that an 'opt out' would mean that the taxpayer had not cooperated and that the case would be returned to CI for further consideration of whether a criminal prosecution would be recommended." Baker and McKenzie, *Undeclared Money Held Offshore: U.S. Voluntary Compliance Programs (Part 2)*, 21 J. Int'l. Tax'n 36, 41 (2010).

<sup>59</sup> See, e.g., Rev. Proc. 2003-11, 2003-1 C.B. 311 (OVCI); Ann. 2004-46, 2004-1 C.B. 964 ("Son-of-Boss" settlement initiative). Such documents are subject to significantly more internal clearance and commentary than changes to the IRS.gov website. The NYSBA has recommended the IRS more explicitly address taxpayer concerns about how the IRS will apply FBAR penalties to those who opt out. See NYSBA Letter. Because voluntary disclosure questions will arise long after the current programs close, it has also recommended the IRS issue a revenue procedure that incorporates public comments. *Id.*

**Timeline of Offshore Voluntary Disclosure Guidance**

1. March 23, 2009 – issued a memo announcing the general terms of the 2009 OVDP<sup>60</sup>
2. May 6, 2009 – posted OVDP Q&A 1-30<sup>61</sup>
3. June 24, 2009 – modified OVDP A26 and added Q&A 31-51 (including FAQ #35)
4. July 31, 2009 – modified OVDP A6, A21, and A22
5. August 25, 2009 – added OVDP Q&A 52
6. January 8, 2010 – added OVDP Q&As 53-54 (after the OVDP ended)
7. March 1, 2011 – issued the undisclosed "March 1 memo" regarding OVDP FAQ #35<sup>62</sup>
8. March 1, 2011 – issued a memo announcing the general terms of the 2011 OVDI<sup>63</sup>
9. February 8, 2011 – posted OVDI FAQ 1-53<sup>64</sup>
10. February 10, 2011 – modified OVDI FAQ 8
11. February 14, 2011 – modified OVDI FAQs 5 and 50
12. March 14, 2011 – modified OVDI A47
13. June 1, 2011 – issued a memo addressing opt-out and removal procedures for both the OVDP and OVDI<sup>65</sup>
14. June 2, 2011 – modified OVDI A52, A51, A32, A35
15. June 2, 2011 – posted OVDI Q&A 25.1, Q&A 51.1, Q&A 51.2, Q&A 51.3
16. August 19, 2011 – modified OVDI A51.2
17. August 26, 2011 – posted OVDI Q&A 24.1
18. August 26, 2011 – revised OVDI Q&A 25.1
19. August 29, 2011 – revised OVDI A1, A11, A15, A17, A18, and A38

Given the informal and constantly-shifting guidance the IRS issued in the form of FAQs and memos, it is no wonder that those taxpayers who would pay less under existing statutes were hesitant to opt out. The IRS would be the first to argue that taxpayers should not rely on FAQs and memos posted to a website. Given the perception that the IRS had

<sup>60</sup> Memorandum from Deputy Commissioner for Services and Enforcement for Commissioner, Large and Mid-Size Business (LMSB) Division and Commissioner, Small Business/Self-Employed (SB/SE) Division, *Authorization to Apply Penalty Framework to Voluntary Disclosure Requests Regarding Offshore Accounts and Entities* (Mar. 23, 2009).

<sup>61</sup> IRS, *Voluntary Disclosure: Questions and Answers*, <http://www.irs.gov/newsroom/article/0,,id=210027,00.html> (first posted May 6, 2009).

<sup>62</sup> Memorandum from Director, SB/SE Examination, and Director, International Individual Compliance, for all OVDI Examiners, *Use of Discretion on 2009 OVDP Cases* (Mar. 1, 2011).

<sup>63</sup> Memorandum from Deputy Commissioner for Services and Enforcement for Commissioner, LB&I Division and Commissioner, SB/SE Division, *Authorization to Apply Penalty Framework to Voluntary Disclosure Requests with Offshore Issues* (Mar. 1, 2011).

<sup>64</sup> IRS, *2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers*, <http://www.irs.gov/businesses/international/article/0,,id=235699,00.html> (first posted Feb. 8, 2011).

<sup>65</sup> Memorandum for Commissioner, LB&I Division and Commissioner, SB/SE Division, from Deputy Commissioner for Services and Enforcement, *Guidance for Opt Out and Removal of Taxpayers from the Civil Settlement Structure of the 2009 OVDP and the 2011 OVDI* (June 1, 2011).

recently reneged on FAQ #35, it had already lost its credibility. Thus, the opt-out memo provided little reassurance to skeptical taxpayers, particularly those who lived overseas or had come to the U.S. to escape repressive foreign governments.

***Requiring taxpayers who would be subject to lesser penalties under existing statutes to opt out of the 2009 OVDP wastes resources and unnecessarily burdens taxpayers.***

By requiring taxpayers who believed they are eligible for lesser penalties under existing statutes to opt out of the 2009 OVDP, the IRS wasted resources and unnecessarily burdened taxpayers. If the taxpayer opted out and the IRS later examined the case, the examiner would have to re-develop the analysis that the prior examiner was required to complete when he or she compared **"the 20 percent offshore penalty to the total penalties that would otherwise apply to a particular taxpayer,"** as required by 2009 OVDP FAQ #35.<sup>66</sup> Moreover, the taxpayer, after having incurred the expense of applying and then being forced to opt out, might not be as cooperative in any future examination, potentially leading to litigation and additional government expense. This is a waste of IRS and taxpayer resources.

On the other hand, if the IRS does not examine the case, it will either have allowed a willful violator to avoid penalties even after nearly completing an examination, or will have given terrible service to a non-willful violator by encouraging him or her to apply and then opt out, without providing any closure.<sup>67</sup> Moreover, the IRS will have severely inconvenienced the taxpayer, burdening him or her with unnecessary expenses and paperwork and threats of prosecution and disproportionate penalties for no good reason. Thus, the IRS's reinterpretation of FAQ #35 – and requiring taxpayers to opt out to obtain lesser penalties that apply under existing statutes – only seems to make sense if coercing taxpayers to agree to pay more than they actually owe is a goal, which it is not.

***Because taxpayers relied on the plain language of FAQ #35, the IRS should have accepted the penalty that would apply under "existing statutes."***

***The public's reasonable interpretation of FAQ #35 is consistent with longstanding IRS policy, the terms of the predecessor to the 2009 OVDP, and concepts of fairness and due process.***

As noted above, the IRS issued the March 1 memo to clarify what the IRS perceived as an "ambiguity" that led examiners to believe they had to accept less than the 20 percent

<sup>66</sup> Memorandum for Commissioner, LB&I Division and Commissioner, SB/SE Division, from Deputy Commissioner for Services and Enforcement, *Guidance for Opt Out and Removal of Taxpayers from the Civil Settlement Structure of the 2009 OVDP and the 2011 OVDI* (June 1, 2011) (noting that if a taxpayer opts out, a committee will determine whether to "reassign" the case for an examination and, if so, to whom). The taxpayer would not be given an opportunity to address the committee. *Id.*

<sup>67</sup> As noted above, IRS guidance indicates that it will examine anyone who withdraws from the 2009 OVDP or 2011 OVDI. See Memorandum for Commissioner, LB&I Division and Commissioner, SB/SE Division, from Deputy Commissioner for Services and Enforcement, *Guidance for Opt Out and Removal of Taxpayers from the Civil Settlement Structure of the 2009 OVDP and the 2011 OVDI* (June 1, 2011).

penalty if a lesser penalty would apply under "existing statutes."<sup>68</sup> The National Taxpayer Advocate does not agree that FAQ #35 is ambiguous. Rather, the IRS examiners' interpretation of FAQ #35 is the most natural reading of its clear and unambiguous language. Many practitioners share this view.<sup>69</sup> Moreover, according to longstanding IRS policy:

An exaction by the United States Government, which is not based upon law, statutory or otherwise, is a taking of property without due process of law, in violation of the Fifth Amendment to the United States Constitution. Accordingly, a Service representative in his/her conclusions of fact or application of the law, shall hew to the law and the recognized standards of legal construction. It shall be his/her duty to determine the correct amount of the tax, with strict impartiality as between the taxpayer and the Government, and without favoritism or discrimination as between taxpayers.<sup>70</sup>

Actually demanding more than a taxpayer owes would legitimize those who (unjustifiably) claim the IRS regularly violates the Constitution. Thus, it is inherently reasonable for the public, the National Taxpayer Advocate, and the IRS's revenue agents to interpret the terms of the 2009 OVDP as not demanding more than would otherwise be due under existing statutes. The IRS simply does not seek to use threats and unequal bargaining power to extract more than a taxpayer owes, particularly after the taxpayer has come forward to make a voluntary disclosure. Moreover, it is reasonable for taxpayers to expect the IRS to apply "existing statutes" which reflect only statutory "maximum" penalty amounts, using the mitigation guidelines and other taxpayer-favorable guidance provided in the current IRM, as described above. This interpretation of FAQ #35 is also consistent with the settlement that the IRS previously offered to FBAR violators pursuant to LCCI, a predecessor of the 2009 OVDP.<sup>71</sup>

<sup>68</sup> We note that President Barack Obama recently signed the *Plain Writing Act of 2010* (H.R. 946), Pub. L. 111-274, Oct. 13, 2010, 124 Stat. 2861 (5 U.S.C. 301 note), to "improve the effectiveness and accountability of Federal agencies to the public by promoting clear Government communication that the public can understand and use." *Id.* It defines "plain writing" as writing that is "clear, concise, well-organized, and follows other best practices appropriate to the subject or field and intended audience." *Id.*

<sup>69</sup> See, e.g., NYSBA Letter ("[M]any taxpayers and practitioners interpreted this third modification [FAQ #35] to mean that the Service would consider whether a taxpayer should be subject to non-willful FBAR penalties as opposed to a 20% miscellaneous penalty..."); CCH Federal Taxes Weekly, *Practitioners' Corner: Bar to Arguing Non-Willfulness Under Offshore Disclosure Programs Creates Concerns*, 2011 No. 13., 153, 155 (Mar. 31, 2011) (quoting Baker Hostetler tax partner, James Mastracchio, as saying: "We were able to make FAQ 35 submissions requesting a review of the willfulness issue all along until February 8 of this year ... [the IRS] seems to be changing the rules of the game halfway through.... the troubling thing is that closing the program to willfulness consideration under FAQ 35 now, based on a resource issue, when some persons have been granted relief, treats similarly situated taxpayers differently."); Mark E. Matthews and Scott D. Michel, *IRS's Voluntary Disclosure Program for Offshore Accounts: A Critical Assessment After One Year*, 181 DTR J-1 (Sept. 21, 2010) (stating "the FAQ 35 process now appears to be a classic 'bait and switch.' Practitioners advised clients that FAQ 35 would offer a chance at penalty mitigation, but now our experience is that the language in that guidance is essentially an empty promise."); Pedram Ben-Cohen, *IRS's Offshore Bait and Switch: The Case for FAQ 35*, 46 DTR J-1 (Mar. 9, 2011) (same).

<sup>70</sup> Policy Statement 4-7; IRM 1.2.13.1.5 (Feb. 23, 1960). While FBAR is not technically a tax, that does not give the IRS a license to extract more than properly due.

<sup>71</sup> See, e.g., CCA 200603026 (Sept. 1, 2005).

***A court could require IRS to apply FAQ #35 consistently.***

Because taxpayers have relied on a reasonable interpretation of FAQ #35, a court might require the IRS to follow it based on the so-called "Accardi" doctrine or similar legal theories based on the "duty of consistency" or "equality of treatment."<sup>72</sup> Courts often acknowledge that taxpayers generally may not rely on the IRM or similar types of guidance.<sup>73</sup> In some cases, however, particularly where taxpayers have reasonably relied on IRS procedures, courts have required the IRS to follow them to avoid inconsistent results.<sup>74</sup> For example, after the IRS issued press releases announcing changes to procedures in the IRM that would require its special agents to give partial Miranda warnings that were not constitutionally required, some courts relied on the Accardi doctrine to suppress evidence obtained by agents who failed to comply with the new procedures.<sup>75</sup> The Accardi doctrine was later limited to situations where taxpayers had detrimentally relied on the government's procedures.<sup>76</sup> If taxpayers relied on the procedures, however, a court could require the IRS to abide by them.

**An unpublished reversal by IRS leaders makes IRS employees look like they are arbitrarily applying FAQ #35, potentially favoring some taxpayers over others.**

The appearance that the IRS is not treating taxpayers consistently (*e.g.*, accepting less than 20 percent before it issued the March 1 memo, but not after) combined with its failure to explain why it was doing so created appearance problems for IRS employees.<sup>77</sup> These

<sup>72</sup> The Accardi doctrine was originally based on an agency's failure to follow its regulations. See, *e.g.*, *Shaughnessy v. United States ex rel Accardi*, 349 U.S. 280, 281 (1955); *Vitarelli v. Seaton*, 359 U.S. 535 (1959). As noted below, however, it has been extended to other guidance and procedures.

<sup>73</sup> See, *e.g.*, *Avers v. Comm'r*, T.C. Memo. 1988-176 ("the I.R.M. requirements are merely directory rather than mandatory, and noncompliance does not render respondent's actions invalid.").

<sup>74</sup> For further discussion of the Accardi doctrine and related legal theories, see, *e.g.*, Thomas W. Merrill, *The Accardi Principle*, 74 Geo. Wash. L. Rev. 569 (2005-2006); Joshua I. Schwartz, *The Irresistible Force Meets the Immovable Object: Estoppel Remedies for an Agency's Violation of Its Own Regulations or Other Misconduct*, 44 Admin. L. Rev. 653 (1992); Christopher M. Pietruszkiewicz, *Does the Internal Revenue Service have a Duty to Treat Similarly Situated Taxpayers Similarly?* 74 U. Cin. L. Rev. 531, 532-534 (2005). Even in the absence of written procedures, the IRS may have a duty of "equality of treatment" and "consistency," but these theories may require the taxpayer to prove competitive disadvantage or invidious discrimination. See, *e.g.*, *Int'l Bus. Machines Corp. v. United States*, 343 F.2d 914 (Ct. Cl. 1965), *cert. denied*, 382 U.S. 1028 (1966) (IRS abused discretion in prospectively (not retroactively) revoking beneficial private ruling given to taxpayer's competitor while denying the taxpayer a similar ruling in the interim). Compare *Avers v. Comm'r*, TC Memo 1988-176 (tax shelter investor not entitled to settlement on terms offered to other shelter investors because the offers were in error and the taxpayer failed to prove discriminatory purpose) with *Sirbo Holdings, Inc. v. Comm'r*, 476 F.2d 981 (2d Cir. 1973) (reasoning the IRS could not settle with one taxpayer while refusing to settle on the same terms with another similarly situated taxpayer without explanation).

<sup>75</sup> See, *e.g.*, *United States v. Heffner*, 420 F.2d 809 (4th Cir. 1969) ("An agency of the government must scrupulously observe rules, regulations, or procedures which it has established. When it fails to do so, its action cannot stand and courts will strike it down.... It is of no significance that the procedures or instructions which the IRS has established are more generous than the Constitution requires.... Nor does it matter that these IRS instructions to Special Agents were not promulgated in something formally labeled a 'Regulation' or adopted with strict regard to the Administrative Procedure Act; the Accardi doctrine has a broader sweep.... The arbitrary character of such a departure is in no way ameliorated by the fact that the ignored procedure was enunciated as an instruction in a 'News Release.')" (internal citations omitted); *United States v. Leahey*, 434 F.2d 7 (1st Cir. 1970) (explaining its suppression of evidence obtained without following IRM procedures: "we have the two factors intersecting: (1) a general guideline, deliberately devised, aiming at accomplishing uniform conduct of officials which affects the post-offense conduct of citizens involved in a criminal investigation; and (2) an equally deliberate public announcement, made in response to inquiries, on which many taxpayers and their advisors could reasonably and expectably rely. Under these circumstances we hold that the agency had a duty to conform to its procedure, that citizens have a right to rely on conformance, and that the courts must enforce both the right and duty").

<sup>76</sup> *United States v. Caceres*, 440 U.S. 741, 752-53 (1979).

<sup>77</sup> According to the IRS, the number of OVDP agreements for less than the 20 percent offshore penalty "is not tracked and therefore cannot be determined." IRS response to TAS information request (Sept. 14, 2011).

employees may have been perceived as arbitrarily providing preferential treatment to some taxpayers and not others, in violation of the rules of ethics.<sup>78</sup>

### The IRS may have violated the Freedom of Information Act.

The Freedom of Information Act requires the IRS to make available to the public all "administrative staff manuals and instructions to staff that affect a member of the public," unless an exemption applies.<sup>79</sup> Thus, the IRS's failure to make its March 1 memo timely available to the public appears to have violated the FOIA.<sup>80</sup> Moreover, if an item is not properly published and the taxpayer is not otherwise given "timely" notice of it, it may not be "relied on, used, or cited" by the IRS against a taxpayer.<sup>81</sup> Accordingly, the IRS's reliance on the March 1 memo may also have violated the FOIA.

## CONCLUSION

The 2009 OVDP appears to have been a great deal for those engaged in criminal tax evasion. They were not affected by the IRS's "clarification" that it would not consider non-willfulness, reasonable cause, or the mitigation guidelines in applying the offshore penalty because their violations were willful and unlikely to qualify for mitigation. However, the IRS is perceived as having "renege[d]" the terms of the 2009 OVDP that would benefit taxpayers whose violations were not willful. Many felt that the IRS placed them in the unacceptable position of having to agree to pay amounts they did not owe or face the prospect the IRS would assert excessive civil and criminal penalties. This perceived reversal burdened taxpayers, wasted resources, violated longstanding IRS policy, opened the IRS to potential legal challenges, and was not properly disclosed as required by FOIA. It also damaged the IRS's credibility. As a result, it is likely to have more difficulty gaining participation in any future settlement initiatives.

<sup>78</sup> The ethical rules applicable to all executive branch employees state: "Employees shall act impartially and not give preferential treatment to any private organization or individual.... Employees shall endeavor to avoid any actions creating the appearance that they are violating the law or the ethical standards set forth in this part." 5 C.F.R. §§ 2635.101(b)(8) and (14). By not timely releasing the March 1 memo or otherwise explaining why it would accept penalties of less than 20 percent for some taxpayers but not others, the IRS fosters the appearance that its employees are violating the ethical rules by giving preferential treatment to some taxpayers but not others.

<sup>79</sup> See 5 U.S.C. § 552(a)(2)(C). No exemptions appear to apply in this case.

<sup>80</sup> See generally, Memorandum from Counsel to SPDR, *Request for Review of Opinion – Instructions to Staff under 5 U.S.C. 552(a)(2)(C)* (July 27, 2011) (suggesting the IRS comply with the requirement to post items "promptly" by doing in the "quarter in which they are issued"). The IRS posted the March 1 memo in response to a Taxpayer Advocate Directive issued by the National Taxpayer Advocate on August 16, 2011. See Taxpayer Advocate Directive 2011-1 (*Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and comply with the Freedom of Information Act*) (Aug. 16, 2011), available at <http://www.irs.gov/advocate/article/0,,id=251887,00.html>. The March 1 memo is now available at [http://www.irs.gov/pub/irs-drop/ovdi\\_memo\\_use\\_of\\_discretion\\_3-1-11.pdf](http://www.irs.gov/pub/irs-drop/ovdi_memo_use_of_discretion_3-1-11.pdf).

<sup>81</sup> According to the law, a "staff manual or instruction that affects a member of the public may be **relied on, used, or cited** as precedent by an agency against a party other than an agency **only** if— (i) it has been indexed and either **made available or published** as provided by this paragraph; or (ii) the party has **actual and timely notice** of the terms thereof." 5 U.S.C. § 552(a)(2)(flush) (emphasis added).

In conclusion, the National Taxpayer Advocate preliminarily recommends that the IRS:<sup>82</sup>

1. Revoke the March 1 memo.
2. Direct all examiners to follow FAQ #35 by not requiring a taxpayer to pay a penalty greater than what he or she would otherwise be liable for under "existing statutes." This direction should clarify that examiners should apply "existing statutes" in the same manner that the IRS applies them outside of the OVDP (*e.g.*, IRM 4.26.16 implements existing statutes by instructing employees to: issue warning letters in lieu of penalties, consider reasonable cause, assert the penalty for willful violations only if the IRS has proven willfulness, impose less than the maximum penalty for failure to report small accounts under "mitigation guidelines," and apply multiple FBAR penalties only in the most egregious cases).<sup>83</sup>
3. Replace all OVD-related frequently asked questions (FAQs) on IRS.gov with guidance published in the Internal Revenue Bulletin, which describes the OVDP and OVDI.<sup>84</sup> This guidance should incorporate comments from the public and internal stakeholders (including the National Taxpayer Advocate). It should reaffirm that taxpayers accepted into the 2009 OVDP will not be required to pay more than the amount for which they would otherwise be liable under existing statutes, as currently provided by 2009 OVDP FAQ #35. It should also direct OVDP examiners to use the taxpayer-favorable provisions of the IRM (described above) to make this determination.
4. Allow taxpayers who agreed to pay more under the 2009 OVDP than the amount for which they believe they would be liable under existing statutes (as implemented by the IRS outside of the OVDP, and described above) the option to elect to have the IRS certify this claim, and offer to amend the closing agreement(s) to reduce the offshore penalty.<sup>85</sup>

<sup>82</sup> On August 16, 2011, the National Taxpayer Advocate directed the IRS to take similar actions by issuing a Taxpayer Advocate Directive (TAD). See Taxpayer Advocate Directive 2011-1 (*Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and comply with the Freedom of Information Act*) (Aug. 16, 2011), available at [www.irs.gov/advocate](http://www.irs.gov/advocate). The IRS appealed the TAD to the Deputy Commissioner for Services and Enforcement. Memorandum for Deputy Commissioner for Services and Enforcement from Commissioner, LB&I and Commissioner, SB/SE, *Appeal of Taxpayer Advocate Directive 2011-1 (Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and comply with the Freedom of Information Act)* (Aug. 30, 2011), available at <http://www.irs.gov/advocate/article/0,,id=251887,00.html>. The National Taxpayer Advocate reiterated these directives in a follow-up memo to the Deputy Commissioner. See Memorandum for Deputy Commissioner for Services and Enforcement from National Taxpayer Advocate, *Appeal of Taxpayer Advocate Directive 2011-1 (Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and comply with the Freedom of Information Act)* (Sept. 22, 2011), available at [www.irs.gov/advocate](http://www.irs.gov/advocate). The IRS did not timely respond to the National Taxpayer Advocate's memo. For a recommendation that would address the IRS's failure to respond to TADs, see Legislative Recommendation: *Codify the Authority of the Office of the Taxpayer Advocate in Precedential Cases, Rule-making, and Systemic Administration*, *infra*.

<sup>83</sup> OVDI FAQ #27 already provides that "the examiner has the right to ask any relevant questions, request any relevant documents, and even make third-party contacts, if necessary to certify the accuracy of the amended returns, without converting the certification to an examination."

<sup>84</sup> This recommendation is consistent with recent comments from external stakeholders. See, *e.g.*, Letter from New York State Bar Association Tax Section to Commissioner, IRS, Chief Counsel, IRS, and Acting Assistant Secretary (Tax Policy) Department of the Treasury, *2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers*, reprinted as, *NYSBA Tax Section Comments on FAQ for 2011 Offshore Voluntary Disclosure Initiative*, 2011 TNT 153-13 (Aug. 9, 2011) (recommending public guidance). Moreover, settlement initiatives are often published in the Internal Revenue Bulletin. See, *e.g.*, Rev. Proc. 2003-11, 2003-1 C.B. 311 (Offshore Voluntary Compliance Initiative (OVCI)); Ann. 2004-46, 2004-1 C.B. 964 ("Son-of-Boss" settlement initiative).

<sup>85</sup> The IRS is already offering to amend 2009 OVDP agreements for taxpayers who would qualify for the reduced five percent or 12.5 percent offshore penalty rates under the 2011 OVDI. See OVDI FAQ #52; OVDI FAQ #53.

## IRS COMMENTS

The IRS strongly disagrees with the inaccurate "bait and switch" characterizations made in the National Taxpayer Advocate's report. The 2009 Offshore Voluntary Disclosure Program (OVDP) was a highly successful program that provided a way for taxpayers with previously undisclosed accounts and unreported income to come into compliance with the U.S. tax laws. As discussed below, the 2009 OVDP was a voluntary program that taxpayers could choose to enter into. If at any time during the certification process, a taxpayer disagreed with the results provided for under the program (*e.g.*, if a taxpayer believed that a facts and circumstances determination would show that penalty mitigation is appropriate), the taxpayer could opt out of the program and its penalty structure. This option is still available today.

Global tax enforcement is a top priority at the IRS, and we have made significant progress on multiple fronts, including ground-breaking international tax agreements and increased cooperation with other governments. In addition, the IRS and Justice Department have increased efforts involving criminal investigation of international tax evasion.

The combination of efforts helped support the 2009 OVDP and the 2011 Offshore Voluntary Disclosure Initiative (OVDI). The programs gave U.S. taxpayers with undisclosed assets or income offshore an opportunity to get compliant with the U.S. tax system, pay their fair share and avoid potential criminal charges.

The 2009 program led to approximately 15,000 voluntary disclosures as well as another 3,000 applicants who came in after the deadline, but were allowed to participate in the 2011 initiative. Beyond that, the 2011 program (with an increased offshore penalty) has generated an additional 12,000 voluntary disclosures.

The goal of the programs was to get individuals back into the U.S. tax system and to turn the tide against offshore tax evasion. The cases came from every corner of the world, with bank accounts covering 140 countries. In addition to billions in revenue, the two disclosure programs provided the IRS with a wealth of information on various banks and advisors assisting people with offshore tax evasion, and the IRS will use this information to continue its international enforcement efforts.

The National Taxpayer Advocate expresses concerns regarding the provisions of FAQ #35 under the 2009 OVDP. The "bait and switch" characterization is incorrect. As noted in the report, an IRS memorandum was issued March 1, 2011, clarifying the intent of FAQ #35 and how it applied. This memorandum was subsequently published on IRS.gov. The OVDP was never intended to allow mitigation of penalties in the certification program. By its nature, OVDP is a settlement program that allows taxpayers a streamlined way to get back into the US tax system without a full examination. OVDP is a certification process, not an examination process. The program was premised on providing taxpayers certainty

regarding the penalty structure (including clarity in the period covered) without a full examination.

It is important to recognize that relief is available to address the issues raised in the report. Throughout the entire program, taxpayers have had the opportunity to opt out of the settlement structure and request an examination if the taxpayer disagrees with the result provided for under the program. An examination is the appropriate forum for detailed facts and circumstances determinations. Moreover, the opt-out procedures and additional guidance issued on June 1, 2011, clarify that, depending on the facts and circumstances, it may be preferable for a particular taxpayer to opt out of the 2009 OVDP or 2011 OVDI and provide guidance for taxpayers regarding the decision whether to opt out.

The IRS disagrees with many assertions made in the report. The IRS did not change the terms of the program mid-stream. The program was never intended to require facts and circumstances determinations to be made within the settlement program. It was, however, always intended that a facts and circumstances determination would be available in an examination following opting out of the settlement program. Taxpayers who opted out of the program remain in the Criminal Investigation program and do not face criminal prosecution to the extent issues were disclosed. In addition, guidance is explicit that in some cases, taxpayers will have the same agent for an examination following opt out. Taxpayers should not feel compelled to stay in OVDP because of fear of opting out.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate generally supports the IRS's efforts to combat offshore tax evasion. However, such efforts should not create confusion or fear in the hearts of those who made honest mistakes. Moreover, even efforts aimed at intentional tax evasion should conform to generally accepted concepts of due process, transparency, and procedural fairness. The way in which the IRS implemented the OVDP and OVDI did not meet those high standards, and likely reduced respect for the U.S. tax system and negatively impacted future compliance, as further described below.

As this report was being prepared, the National Taxpayer Advocate issued a Taxpayer Advocate Directive (TAD) recommending that the IRS take steps similar to the preliminary recommendations described above.<sup>86</sup> SB/SE and LB&I appealed the TAD to the Deputy Commissioner for Services and Enforcement, who modified it.<sup>87</sup> The IRS's formal response (above) is very similar to the Deputy Commissioner's memo, in that it is conclusory and provides little in the way of explanation or rationale. The Deputy Commissioner agreed to release the March 1 memo to the public, but disagreed with the National Taxpayer Advocate's other recommendations. The National Taxpayer Advocate commends the IRS for releasing the memo, as required by law.

Following the Deputy Commissioner's memo, the National Taxpayer Advocate elevated the remaining recommendations to the Commissioner of Internal Revenue for a formal response. For TAS's response to the IRS's comments (above) and the Deputy Commissioner's memo, see the National Taxpayer Advocate's memo to the Commissioner of Internal Revenue (the "Memo to the Commissioner"), which is reprinted immediately following the recommendations section below.<sup>88</sup>

It seems impressive that the OVDP and OVDI brought in about 30,000 taxpayers, as estimated by the IRS comments (above). However, an estimated five to seven million U.S. citizens reside abroad,<sup>89</sup> many of whom have FBAR filing requirements. Many citizens residing in the U.S. also have FBAR filing requirements. Yet, the IRS received only 218,840

<sup>86</sup> See Taxpayer Advocate Directive 2011-1 (*Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and comply with the Freedom of Information Act*) (Aug. 16, 2011), available at <http://www.irs.gov/advocate/article/0,,id=251887,00.html>.

<sup>87</sup> Memorandum for Deputy Commissioner for Services and Enforcement from Commissioner, LB&I and Commissioner, SB/SE, *Appeal of Taxpayer Advocate Directive 2011-1 (Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and comply with the Freedom of Information Act)* (Aug. 30, 2011), available at [www.irs.gov/advocate](http://www.irs.gov/advocate); Memorandum for Deputy Commissioner for Services and Enforcement from National Taxpayer Advocate, *Appeal of Taxpayer Advocate Directive 2011-1 (Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and comply with the Freedom of Information Act)* (Sept. 22, 2011), available at <http://www.irs.gov/advocate/article/0,,id=251887,00.html>.

<sup>88</sup> Memorandum for Commissioner of Internal Revenue from National Taxpayer Advocate, *Recommendations Regarding Taxpayer Advocate Directive 2011-1* (Sept. 26, 2011), available at <http://www.irs.gov/advocate/article/0,,id=251887,00.html>.

<sup>89</sup> IRS website, *Reaching Out to Americans Abroad* (Apr. 2009), <http://www.irs.gov/businesses/article/0,,id=205889,00.html>; W&I Research Study Report, *Understanding the International Taxpayer Experience: Service Awareness, Use, Preferences, and Filing Behaviors* (Feb. 2010) (citing U.S. Department of State data). This number does not include U.S. troops stationed abroad.

FBAR filings in 2008.<sup>90</sup> There is little doubt that a large number of people still have not filed FBARs and many such violations are inadvertent.

As discussed in the Memo to the Commissioner, even if the IRS chooses to ignore the damage caused by its reversal on FAQ #35, it must clarify its seemingly inconsistent statements about what people should do if they learn they have inadvertently failed to file an FBAR. In an effort to encourage taxpayers to enter into the OVDP and OVDI, the IRS emphasized the severe FBAR penalties that could apply outside of these programs, suggesting that the more reasonable provisions of the still-current IRM might be obsolete, and that those making "quiet" corrections might be subject to more severe penalties than they had been in the past. TAS, American Citizens Abroad (an organization representing Americans overseas), and the U.S. Ambassador to Canada have been receiving complaints from people who inadvertently failed to file an FBAR and are confused and worried about how the IRS is administering FBAR penalties both inside and outside of the voluntary disclosure programs.<sup>91</sup>

Many are under the impression the IRS will always seek to apply the maximum FBAR penalty applicable to willful violations, regardless of the situation. The U.S. ambassador to Canada reportedly sought to reassure them, stating:

[The United States] government isn't out to get honest "grandmas" who don't owe anything to the Internal Revenue Service....My message on this is to sit tight. We are not unreasonable. We are not unsympathetic. We are not irresponsible. The IRS is exploring ways to accommodate the roughly one million dual Canadian-American citizens living here.<sup>92</sup>

For nearly two months the IRS responded with deafening silence. As the press continued to repeat the IRS's tough talk about how seemingly minor FBAR violations could trigger draconian penalties and dual citizens tearfully described to reporters how the IRS was actually seeking such outrageous penalties, the IRS declined to comment.<sup>93</sup> Finally, in early December, as this document was in-route to the printer, the IRS posted some guidance on its website, which suggested that it might still apply the reasonable provisions that appear

<sup>90</sup> National Taxpayer Advocate, 2009 Annual Report to Congress 144 (Most Serious Problem: *U.S. Taxpayers Located or Conducting Business Abroad Face Compliance Challenges*).

<sup>91</sup> See, e.g., Barrie McKenna, *Ottawa Seeks Leniency for Canadians in U.S. Tax Hunt*, *The Globe and Mail* (Oct. 18, 2011) ("The U.S. ambassador, along with many federal MPs, have been flooded with calls and e-mails from Canadians worried they'll face punishing penalties..."). For a sample of submissions to TAS's Systemic Advocacy Management System (SAMS) by Canadian residents, see the Memo to the Commissioner, *infra*. See also American Citizens Abroad (ACA), *The FBAR Scam*, [www.aca.ch/fbarscam.pdf](http://www.aca.ch/fbarscam.pdf) (last visited Nov. 16, 2011).

<sup>92</sup> For more detail about problems facing Canadians and possible solutions, see Richard Lipton, *Fear and Loathing North of the Border*, 133 *Tax Notes* 1405 (Dec. 12, 2011).

<sup>93</sup> See, e.g., Amy Feldman, *REFILE-Undisclosed Foreign Accounts? The IRS Is Coming*, *Reuters* (Nov. 9, 2011), <http://www.reuters.com/article/2011/11/09/offshoreaccounts-irs-idUSN1E7A80V920111109>; Amy Feldman, *Taxpayers with Overseas Accounts Seethe at Penalties*, *Reuters* (Dec. 8, 2011), <http://www.reuters.com/article/2011/12/08/us-usa-taxes-foreign-idUSTRE7B723920111208> ("One woman called from Australia on a Sunday night and started crying on the phone; another said she'd gotten psoriasis from the stress. A few were considering expatriating as soon as they could get their taxes in order....The IRS had no comment for this story...").

in IRM 2.26.16, and that it might issue additional guidance.<sup>94</sup> The U.S. ambassador to Canada announced that the guidance would waive penalties against inadvertent late-filers and also allow those who took part in the OVDI and OVDP to get money back, as recommended by the National Taxpayer Advocate.<sup>95</sup> While the IRS-released fact sheet is helpful, it has not been vetted like changes to the IRM or items published in the Internal Revenue Bulletin, and the IRS would be the first to point out that taxpayers generally cannot rely on fact sheets and press releases. As of this writing, we do not know what other steps the IRS will take to address the problem.

## Recommendations

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

1. Revoke the March 1 memo and disclose such revocation as required by the Freedom of Information Act.
2. Immediately direct all examiners to follow FAQ #35 by not requiring a taxpayer to pay a penalty greater than what he or she would otherwise be liable for under "existing statutes." This direction should clarify that examiners should apply "existing statutes" in the same manner that the IRS applies them outside of the OVDP (*e.g.*, IRM 4.26.16 implements existing statutes by instructing employees to: issue warning letters in lieu of penalties, consider reasonable cause, assert the penalty for willful violations only if the IRS has proven willfulness, impose less than the maximum penalty for failure to report small accounts under "mitigation guidelines," and apply multiple FBAR penalties only in the most egregious cases).<sup>96</sup> Post any such guidance in the electronic reading room on IRS.gov, as required by FOIA.
3. Issue a notice or similar public pronouncement that:
  - a. Describes, reaffirms, and expands the taxpayer-favorable procedures provided by IRM 4.26.16;
  - b. Tells people what to do if they discover they have inadvertently failed to file FBARs, reassuring them that they are most likely to receive a warning letter in accordance with the IRM if they follow the instructions provided by the notice;<sup>97</sup>

<sup>94</sup> See, *e.g.*, IRS, *Information for U.S. Citizens or Dual Citizens Residing Outside the U.S.*, FS-2011-13 (Dec. 7, 2011); Kristen A. Parillo, IRS to Minimize Penalties on Dual U.S.-Canadian Citizens Unaware of U.S. Tax Filing Obligations, 2011 TNT 233-9 (Dec. 5, 2011); Marie Sapirie, *Reasonable Cause May Save Expats From Failure-To-File Penalties*, 2011 TNT 237-3 (Dec. 9, 2011).

<sup>95</sup> See *Id.*

<sup>96</sup> OVDI FAQ #27 already provides that "the examiner has the right to ask any relevant questions, request any relevant documents, and even make third-party contacts, if necessary to certify the accuracy of the amended returns, without converting the certification to an examination."

<sup>97</sup> This guidance should address the problems facing Canadians who learn they have failed to file FBARs. For further discussion, see Richard Lipton, *Fear and Loathing North of the Border*, 133 Tax Notes 1405 (Dec. 12, 2011).

- c. Reaffirms that people accepted into the OVDP will not be required to pay more than the amount for which they would otherwise be liable under existing statutes, as currently provided by OVDP FAQ #35 (cross-referencing the guidance issued pursuant to recommendation #2); and
    - d. Commits to replacing all OVD-related frequently asked questions (FAQs), fact sheets, press releases, and memos on IRS.gov with guidance published in the Internal Revenue Bulletin that describes the OVDP, OVDI, and how the IRS will handle voluntary disclosures outside of those programs. This guidance should incorporate comments from all internal and external stakeholders.<sup>98</sup>
  4. Allow taxpayers who agreed, under the OVDP, to pay more than they believe they would be liable for under existing statutes (as implemented by the IRS outside of the OVDP, and described above) the option to elect to have the IRS certify this claim, and offer to amend the closing agreement(s) to reduce the offshore penalty.<sup>99</sup>
  5. Reinstate the International Planning and Operations Council (IPOC) or a similar servicewide forum for addressing international taxpayer issues and vetting international tax compliance initiatives, FAQs, and any similar materials that may appear on the IRS website.

<sup>98</sup> The guidance should address questions currently being posed by practitioners. See, e.g., Scott D. Michel and Mark E. Matthews, *OVDI Is Over – What's Next for Voluntary Disclosures?*, 2011 TNT 201-3 (Oct. 18, 2011); Richard Lipton, *Fear and Loathing North of the Border*, 133 Tax Notes 1405 (Dec. 12, 2011).

<sup>99</sup> The IRS is already offering to amend 2009 OVDP agreements for taxpayers who would qualify for the reduced five percent or 12.5 percent offshore penalty rates under the 2011 OVDI. See OVDI FAQ #52; OVDI FAQ #53.



YOUR VOICE AT THE IRS



THE OFFICE OF THE TAXPAYER ADVOCATE OPERATES INDEPENDENTLY OF ANY OTHER IRS OFFICE AND REPORTS DIRECTLY TO CONGRESS THROUGH THE NATIONAL TAXPAYER ADVOCATE.

Response Due:  
January 26, 2012

October 26, 2011

MEMORANDUM FOR DOUGLAS SHULMAN, COMMISSIONER OF  
INTERNAL REVENUE SERVICE

FROM: Nina E. Olson  
National Taxpayer Advocate

SUBJECT: Recommendations Regarding Taxpayer Advocate Directive 2011-1

Pursuant to Internal Revenue Code section 7803(c)(3), I am submitting recommendations regarding Taxpayer Advocate Directive (TAD) 2011-1. Section 7803(c)(3) provides as follows:

The Commissioner shall establish procedures requiring a formal response to all recommendations submitted to the Commissioner by the National Taxpayer Advocate within 3 months after submission to the Commissioner.

Accordingly, a formal response to the recommendations set forth below is due within **three months**.

## BACKGROUND

### Procedural history

On August 16, 2011, TAD 2011-1 (attached) directed the IRS to take various actions to implement 2009 Offshore Voluntary Disclosure Program (OVD) FAQ #35 and to release an internal memo to the public. On August 30, 2011, Faris Fink, Commissioner, Small Business/Self-Employed (SB/SE) Division and Heather C. Maloy, Commissioner, Large Business & International (LB&I) Division appealed the TAD (attached). They agreed to release the memo, but declined to take the actions relating to the implementation of OVD FAQ #35. On September 22, 2011, I issued a rebuttal memo (attached) to the Deputy Commissioner for Services and Enforcement addressing the points raised in the IRS's appeal and restating our remaining recommendations.

On October 14, 2011, the Deputy Commissioner for Services and Enforcement rescinded the items described in TAD 2011-1 that SBSE and LB&I had not agreed to implement (attached). His memo set forth a conclusion, but did not specifically address the points raised by the TAD or the rebuttal memo. I am submitting recommendations (below) to you for a formal response that includes an analysis of the points raised by this memo, the rebuttal memo, and the TAD.<sup>1</sup>

### Overview of the Problem

*Existing FBAR statutes provide for a wide range of FBAR penalties — severe penalties for “bad actors,” but no significant penalties for “benign actors.”*

Under existing statutes, a “bad actor” who fails to file a Form TD F 90–22.1, *Report of Foreign Bank and Financial Accounts* (FBAR) may face severe civil and criminal penalties, while a “benign actor” may face no penalty at all.<sup>2</sup> For example, if the IRS proves a violation was willful, a person may be liable for civil FBAR penalties of up to 300 percent of the account balance for willful failures continuing over a six-year period (50 percent per year). By contrast, the maximum civil penalty is \$10,000 for each non-willful failure and no penalty may be imposed if the reasonable cause exception applies.

Moreover, because the FBAR statute specifies only a “maximum” penalty amount that the IRS “may” impose, it does not contemplate that the IRS would apply the maximum penalty in every case. Accordingly, Internal Revenue Manual (IRM) section 4.26.16 implements the statute by instructing employees to:

- Issue warning letters in lieu of penalties;
- Consider reasonable cause;
- Assert the penalty for willful violations only if the IRS has proven willfulness;
- Impose less than the maximum penalty for failure to report small accounts under “mitigation guidelines;” and
- Apply multiple FBAR penalties only in the most egregious cases.<sup>3</sup>

As a result, under existing statutes and procedures the IRS would never have asserted multiple FBAR penalties at the maximum rate against a benign actor. Rather, benign actors who came forward to correct a mistake could reasonably expect a penalty that was appropriately calibrated to the severity of the violation, with a warning letter being the most likely outcome in many situations.

<sup>1</sup> Our recommendations (below) have evolved since we issued the TAD, as new information has come to light. The detailed analysis contained in the TAD and the rebuttal memo continue to support the recommendations contained in this memo.

<sup>2</sup> 31 U.S.C. § 5321(a)(5).

<sup>3</sup> IRM 4.26.16.4.4(2) (July 1, 2008) (reasonable cause); IRM 4.26.16.4.5.3 (July 1, 2008) (“The burden of establishing willfulness is on the Service.”); IRM 4.26.16.4.7(3) (July 1, 2008) (warning letter in lieu of penalties); IRM Exhibit 4.26.16-2 (July 1, 2008) (mitigation guidelines); IRM 4.26.16.4.7 (July 1, 2008) (“the assertion of multiple [FBAR] penalties ... should be considered only in the most egregious cases.”).

*OVDP FAQ #35 attracted benign actors by promising to apply "existing statutes."*

Under the OVDP, a person is generally subject to a 20 percent "offshore" penalty in lieu of various penalties, including FBAR.<sup>4</sup> However, OVDP FAQ #35 stated 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." Other FAQs threatened that bad things would happen to those who did not apply to the OVDP.<sup>5</sup> The combination of these warnings and the promise of FAQ #35 prompted many benign actors whose violations were not willful, and who would never have been subject to any significant penalty under existing statutes, to apply to the OVDP.

*On March 1, 2011, the IRS retroactively changed the terms of the OVDP by retracting its promise to apply existing statutes.*

Although the public and IRS revenue agents interpreted FAQ #35 as written, we understand that the IRS actually intended for its agents to compare the 20 percent penalty to the maximum penalty applicable to willful violations, without regard to the willfulness or reasonable cause provisions embedded in existing statutes. On March 1, 2011, more than a year after the 2009 OVDP ended, the IRS issued a memo (the "March 1 memo") instructing OVDP examiners not to consider whether taxpayers would pay less under existing statutes, except in limited circumstances. The March 1 memo is widely viewed as contradicting FAQ #35.

*The IRS's approach treats similarly situated taxpayers differently and turns the burden of proof on its head.*

The IRS's reversal treats those whose OVDP applications were processed before March 1, 2011 differently than those whose applications were processed later. Moreover, even when the IRS made FAQ #35 comparisons after March 1, 2011, it applied existing statutes inconsistently. The IRS did not consistently request information needed to determine if the violation was willful or subject to the reasonable cause exception — some examiners did and some did not. Yet, it used the maximum willful FBAR penalty for comparison purposes unless the *taxpayer proved* the violation was not willful.<sup>6</sup> Thus, some examiners turned the IRS's burden of proof on its head.

<sup>4</sup> Our discussion focuses on the FBAR penalty because it is often the largest and most disproportionate penalty involved.

<sup>5</sup> See OVDP FAQ #3, #10, #12, #14, #15, #34, #49, #50.

<sup>6</sup> IRS response to TAS information request (Aug. 4, 2011) ("In most cases, reasonable cause was not considered since examiners could not make that decision during a certification. Since OVDP cases were certifications and not examinations, it was up to the taxpayer to provide information to substantiate a lower penalty. In cases where clear and convincing documentation was provided by the taxpayer penalties at less than the maximum may have been considered at the discretion of the field subject to concurrence of a Technical Advisor .... Without adequate substantiation, maximum penalties were used for the comparison to the offshore penalty."). This critical aspect of the program was not included in the FAQs nor was it available to taxpayers or IRS employees in any written form. Moreover, it is contrary to the IRS's interpretation of the first sentence of FAQ #35 which states: "Voluntary disclosure examiners do not have discretion to settle cases for amounts less than what is properly due and owing." However, we believe the "discretion" language in the first sentence of FAQ #35 could be interpreted as clarifying that examiners would not have the authority traditionally delegated to Appeals officers to settle cases based on the "hazards of litigation." See, e.g., Policy Statement 8-47, IRM 1.2.17.1.6 (Aug. 28, 2007).

*Benign actors remain confused about how to proceed.*

Now that both the OVDP and the subsequent 2011 Offshore Voluntary Disclosure Initiative (OVDI) are closed to new applicants, benign actors who have failed to file FBARs are confused about what they should do. TAS and the U.S. Ambassador to Canada have apparently been receiving similar complaints from Canadians who are confused and concerned about FBAR penalties.<sup>7</sup> Many appear to be under the impression that the IRS will always seek to apply the maximum FBAR penalty applicable willful violations, regardless of the situation, even outside of the OVDP and OVDI.

## DISCUSSION

**If the IRS does nothing to address OVDP FAQ #35, benign actors will pay more than they should.**

If the IRS does not consider willfulness or reasonable cause, or requires taxpayers to bear the burden of proving nonwillfulness, the benign actors will face a penalty inside the OVDP that is disproportionately harsh — and many are too frightened of the IRS and possible criminal or bankrupting civil penalties to opt out.

This initiative is different from most previous initiatives involving tax shelters because it attracted both bad actors and benign actors who made honest mistakes. If the IRS had clearly communicated that everyone would be presumed to be a bad actor (or willful violator) as the TAD appeal asserts, it would not have attracted benign actors.

The IRS affirmatively attracted benign actors to the OVDP in two ways. First, it announced a method within the OVDP that would treat these differently situated taxpayers differently and fairly — by applying “existing statutes” to benign actors. Second, it threatened that bad things would happen to them outside of the program.<sup>8</sup> The fact that so many benign actors came in for what would be a terrible deal for them if they had understood the IRS's intent (and were afraid to opt out) shows that the IRS did not clearly communicate what it meant to say.

<sup>7</sup> See, e.g., Barrie McKenna, *Ottawa seeks leniency for Canadians in U.S. tax hunt*, The Globe and Mail (Oct. 18, 2011) (“The U.S. ambassador, along with many federal MPs, have been flooded with calls and e-mails from Canadians worried they'll face punishing penalties...”). For a sample of submissions to TAS's Systemic Advocacy Management System (SAMS) by Canadian residents, see attachment 1.

<sup>8</sup> See OVDP FAQ #3, #10, #12, #14, #15, #34, #49, #50.

**If the IRS does nothing to address FAQ #35, both IRS credibility and voluntary compliance is likely to suffer.**

The IRS's miscommunication has consequences. If the government does not appear to treat benign actors fairly when they try to correct honest mistakes, then fewer people (even well-advised people) will try to correct their mistakes, and voluntary compliance will suffer.

Even if it were inclined to do so, the IRS does not have the resources to rely entirely on enforcement. The IRS needs taxpayers to cooperate and comply voluntarily. While an estimated five to seven million U.S. citizens reside abroad,<sup>9</sup> the IRS received only 218,840 FBAR filings in 2008.<sup>10</sup> By comparison, the government closed only 2,386 FBAR examinations and initiated only 21 criminal investigations in 2010.<sup>11</sup> While the OVDP attracted 15,364 applications (perhaps less than one percent of those who did not file FBARs),<sup>12</sup> a more effective initiative would have prompted even more taxpayers to come into compliance without leaving those who did come forward feeling terrified, tricked, or cheated. By generating such ill will and mistrust, the IRS is squandering an opportunity to improve voluntary compliance.

Accordingly, we believe the IRS should create a fair process to evaluate willfulness, reasonable cause, etc. within the OVDP, with the proper burden of proof (on the IRS) as the public understood it to be doing at the outset.<sup>13</sup> Under that approach, the IRS will still have succeeded in bringing the accounts into the open, and collecting all back tax and interest, and most penalties. The alternative, which is akin to a "guilty until proven innocent" approach, is not a good one for an agency of the United States government to follow.

<sup>9</sup> IRS web site, *Reaching Out to Americans Abroad* (Apr. 2009), <http://www.irs.gov/businesses/article/0,,id=205889,00.html>; W&I Research Study Report, *Understanding the International Taxpayer Experience: Service Awareness, Use, Preferences, and Filing Behaviors* (Feb. 2010) (citing U.S. Department of State data). This number does not include U.S. troops stationed abroad.

<sup>10</sup> National Taxpayer Advocate, 2009 Annual Report to Congress 144 (Most Serious Problem: *U.S. Taxpayers Located or Conducting Business Abroad Face Compliance Challenges*).

<sup>11</sup> IRS response to TAS information request (Sept. 14, 2011).

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

<sup>13</sup> A former federal prosecutor involved in the UBS case apparently agrees. See Jeffrey A. Neiman, *Opting Out: The Solution for the Non-Willful OVDI Taxpayer*, 2011 TNT 176-6 (Sept. 7, 2011) ("While the IRS does not have unlimited resources, an expedited review process could have been established to compare the facts and circumstances of an individual taxpayer's overseas account to a set of predetermined objective factors that would have allowed the IRS to assess a reasonable and fair FBAR-related penalty and avoided higher penalties for non-willful taxpayers.").

**The IRS might have avoided the FAQ #35 miscommunication problem by vetting or clearing the OVDP with internal and external stakeholders.**

If the IRS had more thoroughly vetted the OVDP FAQs and the March 1 memo with internal or external stakeholders, it might have avoided the miscommunication problems described above and in the TAD.<sup>14</sup> The IRS recently replaced the International Planning and Operations Council (IPOC), the only service-wide forum for addressing international taxpayer issues, with separate "bilateral" meetings between LB&I and each of the other divisions. If the IPOC had been consulted about the OVDP FAQs, it might have alerted the IRS to the fact that benign actors and IRS revenue agents were going to be confused. If TAS had been consulted about the OVDP FAQs, we might have pointed out the apparent inconsistencies between the IRS's intent and the plain language of the FAQs. Similarly, if the IRS had published the OVDP guidance in the Internal Revenue Bulletin, as it has done with respect to prior settlement initiatives, both internal and external stakeholders would have had the opportunity to identify ambiguities and potential problems.<sup>15</sup>

**If the IRS does not issue additional clarifying guidance about how it will administer the FBAR penalties, the millions of benign actors who have not filed FBARs will remain confused.**

The IRS has been talking tough about how it may impose severe penalties against anyone who did not apply to the OVDP and OVDI. For example, recent IRS statements include:

Those taxpayers making 'quiet' disclosures should be aware of the risk of being examined and potentially criminally prosecuted for all applicable years. OVDP FAQ #10.

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Taxpayers who do not submit a voluntary disclosure run the risk of detection by the IRS and the imposition of substantial penalties, including the fraud penalty and foreign information return penalties, and an increased risk of criminal prosecution. OVDP FAQ #3.

\*\*\*

Failing to file an FBAR subjects a person to a prison term of up to ten years and criminal penalties of up to \$500,000. OVDP FAQ #14.

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<sup>14</sup> For further discussion of transparency, see National Taxpayer Advocate 2011 Annual Report to Congress (Most Serious Problem: *The IRS's Failure to Consistently Vet and Disclose its Procedures Harms Taxpayers, Deprives it of Valuable Comments, and Violates the Law*).

<sup>15</sup> Settlement initiatives are often published in the Internal Revenue Bulletin after being vetted internally and with the Treasury Department. See, e.g., Rev. Proc. 2003-11, 2003-1 C.B. 311 (Offshore Voluntary Compliance Initiative (OVCI)); Ann. 2004-46, 2004-1 C.B. 964 ("Son-of-Boss" settlement initiative).

[For those who opt out of the OVDP] All relevant years and issues will be subject to a complete examination. At the conclusion of the examination, all applicable penalties (including information return and FBAR penalties) will be imposed. Those penalties could be substantially greater than the 20 percent penalty. OVDP FAQ #34.

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[Q] Is the IRS really going to prosecute someone who filed an amended return and correctly reported all their income? ... [A] When criminal behavior is evident and the disclosure does not meet the requirements of a voluntary disclosure under IRM 9.5.11.9, the IRS may recommend criminal prosecution to the Department of Justice. OVDP FAQ #49.

As noted above, this tough talk has created confusion and consternation, particularly among U.S. citizens living abroad. *Yet, the IRS has remained silent about the seemingly reasonable way in which the IRM suggests that it will apply FBAR penalties.* The IRS could help to allay these concerns by issuing a notice or similar public pronouncement that describes what benign actors should do, and emphasizes that they will often not be subject to any penalties under existing statutes.<sup>16</sup> The IRS could further allay these concerns by initiating a public guidance project, which incorporates comments from all internal and external stakeholders, and describes how it will administer FBAR penalties and its voluntary disclosure practice in the future.<sup>17</sup>

## RECOMMENDATIONS

In summary, I recommend the IRS take the following actions:

1. Revoke the March 1 memo and disclose such revocation as required by the Freedom of Information Act (FOIA).
2. Immediately direct all examiners to follow FAQ #35 by not requiring a taxpayer to pay a penalty greater than what he or she would otherwise be liable for under "existing statutes." This direction should clarify that examiners should apply "existing statutes" in the same manner that the IRS applies them outside of the OVDP (*e.g.*, IRM 4.26.16 implements existing statutes by instructing employees to: issue warning letters in lieu of penalties, consider reasonable cause, assert the penalty for willful violations only if the IRS has proven willfulness, impose less than the maximum penalty for failure to report small accounts under "mitigation guidelines," and apply multiple

<sup>16</sup> If necessary, the IRS could create an expedited review procedure for processing voluntary disclosures from taxpayers whose violations were unlikely to have been willful.

<sup>17</sup> This recommendation is consistent with recent comments from external stakeholders. See, *e.g.*, Letter from New York State Bar Association Tax Section to Commissioner, IRS, Chief Counsel, IRS, and Acting Assistant Secretary (Tax Policy) Department of the Treasury, *2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers*, reprinted as, NYSBA Tax Section Comments on FAQ for 2011 Offshore Voluntary Disclosure Initiative, 2011 TNT 153-13 (Aug. 9, 2011) (recommending public guidance).

FBAR penalties only in the most egregious cases).<sup>18</sup> Post any such guidance in the electronic reading room on IRS.gov, as required by FOIA.

3. Issue a notice or similar public pronouncement that:
  - a. Describes and reaffirms the taxpayer-favorable procedures provided by IRM 4.26.16;
  - b. Tells people what to do if they discover they have inadvertently failed to file FBARs, reassuring them that they are most likely to receive a warning letter in accordance the IRM if they follow the instructions provided by the notice;
  - c. Reaffirms that people accepted into the OVDP will not be required to pay more than the amount for which they would otherwise be liable under existing statutes, as currently provided by OVDP FAQ #35 (cross referencing the guidance issued pursuant to recommendation #2); and
  - d. Commits to replacing all OVD-related frequently asked questions (FAQs) and memos on IRS.gov with guidance published in the Internal Revenue Bulletin that describes the OVDP, OVDI, and how the IRS will handle voluntary disclosures outside of those programs in the future. This guidance should incorporate comments from all internal and external stakeholders.<sup>19</sup>
4. Allow taxpayers who agreed to pay more under the OVDP than the amount for which they believe they would be liable under existing statutes (as implemented by the IRS outside of the OVDP, and described above) the option to elect to have the IRS certify this claim, and offer to amend the closing agreement(s) to reduce the offshore penalty.<sup>20</sup>
5. Reinstate the International Planning and Operations Council (IPOC) or a similar service-wide forum for addressing international taxpayer issues and vetting international tax compliance initiatives.

#### Attachments

1. Canadian Offshore Voluntary Disclosure Issues, A Sample of Submissions to the IRS's Systemic Advocacy Management System (SAMS) (Oct. 11, 2011).

<sup>18</sup> OVDI FAQ #27 already provides that "the examiner has the right to ask any relevant questions, request any relevant documents, and even make third-party contacts, if necessary to certify the accuracy of the amended returns, without converting the certification to an examination."

<sup>19</sup> The guidance should address questions currently being posed by practitioners. See, e.g., Scott D. Michel and Mark E. Matthews, *OVDI is Over – What's Next for Voluntary Disclosures?*, 2011 TNT 201-3 (Oct. 18, 2011).

<sup>20</sup> The IRS is already offering to amend 2009 OVDP agreements for taxpayers who would qualify for the reduced 5 percent or 12.5 percent offshore penalty rates under the 2011 OVDI. See OVDI FAQ #52; OVDI FAQ #53.

2. Taxpayer Advocate Directive 2011-1 (Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and comply with the Freedom of Information Act) (Aug. 16, 2011).
3. Memorandum for Deputy Commissioner for Services and Enforcement, from Commissioner, Small Business/Self-Employed (SB/SE) Division and Commissioner, Large Business & International (LB&I) Division, *Appeal of Taxpayer Advocate Directive 2011-1 (Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and comply with the Freedom of Information Act)* (Aug. 30, 2011).

Memorandum for Deputy Commissioner for Services and Enforcement, from National Taxpayer Advocate, *Appeal of Taxpayer Advocate Directive 2011-1 (Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and comply with the Freedom of Information Act)* (Sept. 22, 2011).

Memorandum for National Taxpayer Advocate, from Deputy Commissioner for Services and Enforcement, *Taxpayer Advocate Directive 2011-1* (Oct. 14, 2011).

cc: Steven T. Miller, Deputy Commissioner for Services and Enforcement  
 William J. Wilkins, Chief Counsel  
 Heather C. Maloy, Commissioner, Large Business and International Division  
 Faris R. Fink, Commissioner, Small Business/Self-Employed Division  
 Nikole Flax, Assistant Deputy Commissioner, Services and Enforcement  
 Jennifer Best, Special Assistant to the Commissioner  
 Ken Drexler, Senior Advisor to the National Taxpayer Advocate  
 Eric LoPresti, Senior Attorney Advisor to the National Taxpayer Advocate  
 Rosty Shiller, Attorney-Advisor to the National Taxpayer Advocate  
 Judy Wall, Special Counsel to the National Taxpayer Advocate

## Canadian Offshore Voluntary Disclosure Issues

### A Sample of Submissions to the IRS's Systemic Advocacy Management System (SAMS)

#### 22133 - Voluntary Offshore Disclosure Harms Citizens

USA citizens living in Canada are not hiding money. Many of us are married to Canadian Citizens and have accounts established for daily living. Interest earned is available through the annual Canadian income tax. Are we interpreting the media reports incorrectly? I was only aware of filing a tax return when there was income in the USA and everybody I have talked to have said the same thing. The penalties are astronomical and we don't know who our voice is. Thanks [name redacted]

#### 22134 - Offshore Voluntary Disclosure Initiative (OVDI)

Just came to know that even though I'm on visa in US, I've to report my foreign accounts. And 2011 OVDI is the only way to get into compliance now. I've foreign accounts where I've sent my W2 taxed savings. I was not aware that even though I am on VISA, I have to report this. Now paying 25% penalty on my already taxed income is like taking away my 2-3 years of my savings completely. This money I've been saving to buy an apartment for my family but now all those dreams are shattered. If I do amend my returns outside the program there is risk of audit with may be max penalties. There is no clear solution. My case is not like I'd foreign business or other sources of income which I tried to hide. It is a plain case of an immigrant who is sending his savings back home. There is interest income of around 25K over the past few years and the total tax I have to owe would be around 2K after taking the foreign tax credit. Now, paying around 35K just because I failed to report this due to my lack of clear understanding of this fact is heart breaking. There is tremendous mental pressure and don't know what to do. If you can please request the government to relax the law if its W2 savings only or give us a fair chance to represent our case without threatening of max penalty, it would be helpful. Not only more folks will come in but it will serve the compliance issue in much proficient manner. As of now for us the only options are either pay our hard earned savings or just return to our home country. Please help.

#### 22173 - Filing Requirements for Americans Living Abroad

My wife is a U.S. Citizen. She has been living with me in Canada since 1999. I recently discovered that she should be filing a U.S. tax return each year. Where can we get help with this? I have searched your website and the U.S. Consulate website for help. I am looking for someone to advise me as to exactly what forms would be applicable for our case so that we may comply. I may also need help in completion of the forms. This issue affects tens of thousands of dual Citizens who were unaware and are in need of your assistance in order to comply with US tax laws. Thank you.

**22195 - No Help or Advocacy Available for Canadians**

There does not seem to be ANY U.S. tax help available for Canadians. I have searched the IRS website thoroughly. On the website there are all kinds of numbers and e-mail addresses and websites where you can go for help or to find a tax advocate or contact a local tax office. These are available for all 50 states, for Puerto Rico and USVI - tax help is even available for people who live in Beijing. But not for Canada, which is like a blank hole on the map.

**22203 - Unfairly Taxing Expats in Canada**

September 6, 2011

This letter was printed in the Vancouver Sun today. I agree completely and have nearly the identical story to the author. Please read and intervene on the IRS assault on Canadian citizens.

My three concerns are:

1. As an individual who has not lived, worked, or been associated with the United States for many years, as someone who has paid Canadian taxes for an extended period of time, and as a person who in opting for Canadian citizenship in 1986 saw it as a renunciation of US citizenship, why should I be penalized a minimum of 5% of my Canadian assets by the IRS?
2. What is particularly disturbing is the position of the children of U.S. citizens who reside in Canada. According to the US House of Representatives website which ... provides for automatic U.S. citizenship to children born outside the U.S. where one or both parents are considered US citizens. This means that our children are considered US citizens and subject to the provisions of the IRS, i.e., they too must file US taxes and disclosures, and suffer the consequences of the IRS pursuit of undisclosed non-US financial accounts. These children, however, are Canadian; they were born in Canada; they have never lived or worked in the United States; in many cases they have never set foot south of the border; and they have no affiliation with the U.S. government. They should not be subject to U.S. taxes and disclosures, and the substantial IRS penalties for non-disclosure.
3. There is also my exposure to the U.S. Estate Tax. My accountant has confirmed that yes, upon my death, since the US considers me a citizen my children will be subject to the U.S. Estate Tax as well as any taxes levied by the Canadian government. This means that my children will be subject to both Canadian and U.S. estate taxes, probation, et al. This amounts to a double taxation which is unfair. I suggest to you that the U.S. Estate Tax be waived for those assets which are clearly Canadian.

**22393 - OVDI Dual Taxation**

I am a Canadian citizen and have been for 30 years. I was born in the US and moved back to Canada with my parents when I was 3 months old. I applied and received my Canadian citizenship when I was 22 years old. Today (Sept 22, 2011), from the CBC radio news, I found out that I am suppose to be filing taxes with the US. I am in shock and very upset! I have never lived and worked in the US. I have never owned property in the U.S. I do not consider myself a U.S. taxpayer. I consider myself a Canadian taxpayer and have never once received any benefit from the U.S. There was an amnesty to voluntarily disclose but this ended Sept 9th, 2011. Now what?? If I am considered a U.S. citizen, as an advocacy for U.S. taxpayers, I would like to know what your organization is doing about this. The penalty, I am assuming, that I would have to pay will steal from me all of my savings for my children's education.

**22433 - Lack of Information on Taxes for Dual Citizenships**

I was born in Canada; my mother is from the United States. When I was a born, my mother applied for me to get dual citizenship, and I received a certificate of birth abroad. I am now 30 years old, and just now discovering that it is required for me to have been filing tax returns in the U.S., even though I wasn't born and have never lived in the United States. As a Canadian there was no clear way for me to be aware of this. There has been no attempt by the IRS to contact me to notify me that I haven't filed and am past due. I am now stuck trying to figure out how, and how many years I need to file for. This is becoming a big deal to friends and family I know that live here in Canada. Being born and raised in Canada there is no way for me to have known about these requirements. I see this as a major problem as there may be penalties for me not having done so.

**22497 - FBAR Penalties Harm Canadian Dual Citizens**

Dear SAMS,

I was born in the US, but immigrated to Canada 43 years ago, married a Canadian and became a Canadian citizen five years later. Since then I have resided, worked and paid taxes in Canada, and never had any U.S. source income or U.S. assets of any kind. I never renewed my U.S. passport and entered the U.S. only for short family visits or vacations. I consider myself a Canadian.

With no U.S. income or assets, I had no reason to assume you needed to file U.S. tax returns, and had never heard of FBAR reports. In 2010, my mother's U.S. accountant, after completing her estate taxes, assured me I had no further personal filing obligations.

At retirement age, I suddenly find out that the IRS claims I owe them \$70,000 for not annually filing a 1-page form reporting my "offshore" Canadian bank and investment accounts!! They threaten to take EVERYTHING if I resist their claims, but offer an "amnesty" if you come forward and file the FBARs. It holds out the prospect of reducing the penalty to zero, but in practice the IRS apparently always claims 5-25% of the money, including that of my Canadian husband since we converted to joint accounts in November, 2010 after I was re-diagnosed with lymphoma.



YOUR VOICE AT THE IRS



THE OFFICE OF THE TAXPAYER ADVOCATE OPERATES INDEPENDENTLY OF ANY OTHER IRS  
OFFICE AND REPORTS DIRECTLY TO CONGRESS THROUGH THE NATIONAL TAXPAYER ADVOCATE.

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August 16, 2011

MEMORANDUM FOR HEATHER C. MALOY, COMMISSIONER,  
LARGE BUSINESS & INTERNATIONAL DIVISION  
FARIS FINK, COMMISSIONER,  
SMALL BUSINESS/SELF-EMPLOYED DIVISION

FROM: Nina E. Olson  
National Taxpayer Advocate

SUBJECT: *Taxpayer Advocate Directive 2011-1 (Implement 2009 Offshore Voluntary Disclosure  
Program FAQ #35 and comply with the Freedom of Information Act).*

### TAXPAYER ADVOCATE DIRECTIVE

I am issuing this Taxpayer Advocate Directive (TAD) to direct that within **15 business days** the Commissioner, Large Business and International Division (LB&I) and the Commissioner, Small Business/Self-Employed (SB/SE) Division take the actions described in the numbered sections below. Within **10 business days** please also provide me with a written response to this TAD discussing the action(s) you plan to take and whether you plan to appeal.<sup>1</sup>

1. Disclose the March 1, 2011 memo for Offshore Voluntary Disclosure Initiative (OVDI) Examiners that addresses the use of discretion in 2009 Offshore Voluntary Disclosure Program (OVDP) cases (the "March 1 memo") on IRS.gov, as required by the Freedom of Information Act (FOIA) (whether or not it is revoked).<sup>2</sup>
2. Revoke the March 1 memo and disclose such revocation as required by FOIA.
3. Immediately direct all examiners that when determining whether a taxpayer would be liable for less than the "offshore penalty" under "existing statutes," as required by 2009 OVDP FAQ #35 (described below), they should not assume the violation was willful unless the taxpayer proves it was not. Direct them to use standard examination procedures to determine whether

<sup>1</sup> See IRM 13.2.1.6, *Taxpayer Advocate Directives* (July 16, 2009).

<sup>2</sup> Memorandum from Director, SB/SE Examination, and Director, International Individual Compliance, for all OVDI Examiners, *Use of Discretion on 2009 OVDP Cases* (Mar. 1, 2011).

a taxpayer would be liable for a lesser amount under existing statutes (*e.g.*, because the taxpayer was eligible for (a) the reasonable cause exception, (b) a non-willful penalty because the IRS lacked evidence to establish its burden to prove willfulness, or (c) application of the mitigation guidelines set forth in the IRM) without shifting the burden of proof onto the taxpayer.<sup>3</sup> Post any such guidance on IRS.gov. Commit to replace the March 1 memo and all OVD-related frequently asked questions (FAQs) on IRS.gov with guidance published in the Internal Revenue Bulletin, which describes the OVDP and OVDI.<sup>4</sup> This guidance should incorporate comments from the public and internal stakeholders (including the National Taxpayer Advocate). It should reaffirm that taxpayers accepted into the 2009 OVDP will not be required to pay more than the amount for which they would otherwise be liable under existing statutes, as currently provided by 2009 OVDP FAQ #35. It should also direct OVDP examiners to use standard examination procedures to make this determination, as provided in item #3 (above); and

4. Allow taxpayers who agreed to pay more under the 2009 OVDP than the amount for which they believe they would be liable under existing statutes the option to elect to have the IRS verify this claim (using standard examination procedures, as described above), and in cases where the IRS verifies it, offer to amend the closing agreement(s) to reduce the offshore penalty.<sup>5</sup>

## I. AUTHORITY

Delegation Order No. 13-3 grants the National Taxpayer Advocate the authority to issue a TAD to mandate administrative or procedural changes to improve the operation of a functional process or to grant relief to groups of taxpayers (or all taxpayers) "when implementation will protect the rights of taxpayers, prevent undue burden, ensure equitable treatment or provide an essential service to taxpayers."<sup>6</sup> For the reasons described below, the IRS's failure to implement 2009 OVDP FAQ #35 violates taxpayer rights, imposes undue burden, results in inequitable treatment of taxpayers, and has likely undermined respect for the IRS and the tax system.

<sup>3</sup> OVDI FAQ #27 already provides that "the examiner has the right to ask any relevant questions, request any relevant documents, and even make third party contacts, if necessary to certify the accuracy of the amended returns, without converting the certification to an examination."

<sup>4</sup> This directive is consistent with recent comments from external stakeholders. See, *e.g.*, Letter from New York State Bar Association Tax Section to Commissioner, IRS, Chief Counsel, IRS, and Acting Assistant Secretary (Tax Policy) Department of the Treasury, *2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers*, reprinted as, NYSBA Tax Section Comments on FAQ for 2011 Offshore Voluntary Disclosure Initiative, 2011 TNT 153-13 (Aug. 9, 2011) (recommending public guidance). Moreover, settlement initiatives are often published in the Internal Revenue Bulletin. See, *e.g.*, Rev. Proc. 2003-11, 2003-1 C.B. 311 (Offshore Voluntary Compliance Initiative (OVCI)); Ann. 2004-46, 2004-1 C.B. 964 ("Son-of-Boss" settlement initiative).

<sup>5</sup> The IRS is already offering to amend 2009 OVDP agreements for taxpayers who would qualify for the reduced 5 percent or 12.5 percent offshore penalty rates under the 2011 OVDI. See OVDI FAQ #52; OVDI FAQ #53.

<sup>6</sup> Internal Revenue Manual (IRM) 1.2.50.4, Delegation Order 13-3 (formerly DO-250, Rev. 1), *Authority to Issue Taxpayer Advocate Directives* (Jan. 17, 2001). See also IRM 13.2.1.6, *Taxpayer Advocate Directives* (July 16, 2009).

Prior to issuing this TAD, the Taxpayer Advocate Service (TAS) raised concerns about 2009 OVDP FAQ #35 with the IRS on multiple occasions. On March 18, 2011, my staff met with the Deputy Commissioner's staff to express my concerns. I also personally discussed the problem with the Commissioner of Internal Revenue. On April 26, 2011, I issued a Taxpayer Assistance Order (TAO) to the LB&I Commissioner, which described my concerns in writing. On April 27, 2011, in a memo that requested both IRS executives and subject matter experts for my staff to work with, I informed each operating division, the Commissioner, and the Deputy Commissioner that we had heard complaints about the OVDP, and would likely discuss the problem in the National Taxpayer Advocate Annual Report to Congress.<sup>7</sup> My staff have contacted SB/SE and LB&I at various levels seeking to address these concerns in cases involving taxpayers who sought assistance from TAS. On June 30, 2011, I raised my concerns again in the National Taxpayer Advocate's Fiscal Year 2012 Objectives Report to Congress.<sup>8</sup> To date, the IRS has not adequately addressed these concerns. Therefore, the procedural requirements for issuing this TAD are satisfied.<sup>9</sup>

## II. DISCUSSION

### Background

U.S. persons are generally required to report foreign financial accounts on Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts (FBAR)* and to report income from such accounts on U.S. tax returns. Leaving aside criminal penalties, the maximum civil penalty for a series of missed FBAR filings can be financially devastating — an amount equal to the greater of \$100,000 or 50 percent of the account balance for each violation each year, potentially accruing to the greater of \$600,000 or 300 percent of each account balance over a six year period — an amount that the Internal Revenue Manual (IRM) acknowledges “can greatly exceed an amount that would be appropriate in view of the violation.”<sup>10</sup>

With significant FBAR penalties as leverage, the IRS “strongly encouraged” people who failed to file these and similar returns and report income from foreign accounts to participate in the 2009 Offshore Voluntary Disclosure Program (OVDP),

<sup>7</sup> Memorandum from National Taxpayer Advocate, *The National Taxpayer Advocate's 2011 Annual Report to Congress-Contact and Subject Matter Expert Request for Potential Most Serious Problems* (Apr. 27, 2011).

<sup>8</sup> National Taxpayer Advocate Fiscal Year 2012 Objectives Report to Congress 23-24 (*IRS's Inconsistency and Failure to Follow Its Published Guidance Damaged Its Credibility with Practitioners Involved in the Voluntary Disclosure Program*).

<sup>9</sup> IRM 13.2.1.6.1 (July 16, 2009).

<sup>10</sup> IRM 4.26.16.4(5) (July 1, 2008); 31 U.S.C. § 5321(a)(5)(C) (willful FBAR penalty); 31 U.S.C. § 5321(b)(1) (indicating a six-year period of limitations applies to FBAR violations).

rather than quietly filing amended returns and paying any taxes due.<sup>11</sup> It warned that taxpayers making "quiet" corrections could be "criminally prosecuted," while OVDP participants would generally be subject to a 20 percent "offshore" penalty in lieu of various other penalties, including the FBAR penalty.<sup>12</sup> While the OVDP appeared to be a great deal for those involved in criminal tax evasion, it was a terrible deal for many whose violations were not willful or who would be eligible for reasonable cause exceptions.

**Example.** Compare person A, a U.S. citizen and resident, who evades tax on income that he hid in an offshore account in Country A, with person B, a U.S. resident and citizen of Country B, who paid tax to Country B on income which he put into a retirement account in Country B before arriving in the U.S.<sup>13</sup> A's failure to report income and file FBARs in the U.S. was willful and B's failure was not. The maximum civil penalty for willful FBAR violations is the greater of \$100,000 or 50 percent of the account value per year, but the maximum for non-willful violations is \$10,000 and no penalty applies to those who qualify for the reasonable cause exception.<sup>14</sup> Moreover, given the way in which the IRS has historically administered the statute outside of the OVDP, B might have received a warning letter for failing to file FBARs.<sup>15</sup> Thus, the 20 percent offshore penalty is a great deal for A but not for B. B would have paid less outside the OVDP.

The IRS announced, however, in OVDP FAQ #35 that:

**Voluntary disclosure examiners do not have discretion to settle cases for amounts less than what is properly due and owing. These examiners will compare the 20 percent offshore penalty to the total penalties that would otherwise apply to a particular taxpayer. Under no circumstances will a taxpayer be required to pay a penalty greater than what he would otherwise be liable for under existing statutes.<sup>16</sup>**

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- <sup>11</sup> See IRS, *Voluntary Disclosure: Questions and Answers*, <http://www.irs.gov/newsroom/article/0,,id=210027,00.html> (Feb. 9, 2011) (first posted May 6, 2009) (hereinafter OVDP "FAQ"). According to the IRS, "[t]axpayers are strongly encouraged to come forward under the Voluntary Disclosure Practice.... Those taxpayers making "quiet" disclosures should be aware of the risk of being examined and potentially criminally prosecuted for all applicable years.... The IRS will be closely reviewing these returns to determine whether enforcement action is appropriate." OVDP FAQ #10. The IRS affirmatively advised "...the voluntary disclosure process is appropriate for most taxpayers who have underreported their income with respect to offshore accounts..." OVDP FAQ #50.
- <sup>12</sup> OVDP FAQ #12. This discussion focuses on the civil FBAR penalty because it is often the largest penalty for which the offshore penalty is a substitute. See 31 USC § 5321.
- <sup>13</sup> Another common "non-willful" situation involves a U.S. resident who maintains an account in another country as a convenient way to send funds to relatives. Alternatively, a U.S. citizen may be living and paying taxes in a foreign jurisdiction, yet oblivious to U.S. filing and reporting obligations.
- <sup>14</sup> See 31 U.S.C. § 5321(a).
- <sup>15</sup> IRM 4.26.16.4.7(3) (July 1, 2008).
- <sup>16</sup> OVDP FAQ #35 (Emphasis added.). The FAQ discussion of "discretion" could reasonably be interpreted as clarifying that examiners would not have the authority traditionally delegated to Appeals officers to settle cases based on the "hazards of litigation." See, e.g., Policy Statement 8-47, IRM 1.2.17.1.6 (Aug. 28, 2007).

As noted above, "existing statutes" applicable to FBAR violations provide for a reasonable cause exception, apply a lower maximum penalty to non-willful violations, and place the burden of proving willfulness upon the IRS.<sup>17</sup> The IRS's implementation of existing statutes also requires that it apply significantly less than the statutory maximum penalty amounts to certain taxpayers with relatively low account balances under "mitigation" guidelines.<sup>18</sup> Thus, taxpayers who would not have been subject to significant penalties because their violations were not willful, because they had relatively low account balances, or because they qualified for the "reasonable cause" exception believed the statement "[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" applied to them.

It seemed reasonable for taxpayers to believe the IRS would adhere to the publicly-announced terms of the program and make this comparison as part of the 2009 OVDP because it did so under the Last Chance Compliance Initiative (LCCI), the predecessor of the OVDP.<sup>19</sup> Under the LCCI, examiners were expressly directed to apply FBAR mitigation guidelines to avoid inappropriately high FBAR penalties.<sup>20</sup>

#### What procedures are causing a problem?

On March 1, 2011, more than a year after the 2009 OVDP ended, after learning that examiners were spending the time to compare the 20 percent penalty to what would be due under existing statutes, the IRS "clarified" its seemingly unambiguous statement in FAQ #35.<sup>21</sup> The March 1 memo directed examiners to stop accepting less than the 20 percent offshore penalty under the 2009 OVDP regardless of whether a taxpayer would pay less under existing statutes, except in narrow circumstances. Even in those few cases where the IRS was supposedly still applying FAQ #35, it generally did not consider reasonable cause and

<sup>17</sup> See 31 U.S.C. § 5321(a)(5). See also *Ratzlaf v. United States*, 510 U.S. 135, 141 (1994); *U.S. v. Williams*, 2010-2 USTC ¶ 50,623 (E.D. VA. 2010); CCA 200603026 (Sept. 1, 2005) (noting "there is no willfulness if the account holder has no knowledge of the duty to file the FBAR," that "the criteria for assertion of the civil FBAR penalty are the same as the burden of proof that the Service has when asserting the civil fraud penalty under IRC section 6663... [that the IRS will have to show] 'clear and convincing evidence,' [of willfulness]," and that "the presumption of correctness with respect to tax assessments would not apply to an FBAR penalty assessment for a willful violation"); IRM 4.26.16.4.5.3(1)-(3) (July 1, 2008) ("(1) The test for willfulness is whether there was a voluntary, intentional violation of a known legal duty. (2) A finding of willfulness under the BSA must be supported by evidence of willfulness. (3) The burden of establishing willfulness is on the Service.").

<sup>18</sup> See generally IRM 4.26.16 (July 1, 2008).

<sup>19</sup> See e.g., CCA 200603026 (Sept. 1, 2005) (noting that [the LCCI letter] "says, 'Also, civil penalties for violations involving [FBARs] will be imposed for only one year and we may resolve the FBAR penalty for less than the statutory amount based on the facts and circumstances of your case.' The instructions to agents contained in the Guidelines for Mitigation of the FBAR Civil Penalty for LCCI Cases provide: 'The examiner may determine that the facts and circumstances of a particular case may warrant that a penalty under these guidelines is not appropriate or that a lesser amount than the guidelines would otherwise provide is appropriate.' If agents follow these guidelines we need not be imposing the FBAR penalty arbitrarily in cases in which it clearly does not apply.").

<sup>20</sup> See, e.g., IRM Exhibit 4.26.16-4 (July 1, 2008) (LCCI penalty mitigation guidelines).

<sup>21</sup> Memorandum from Director, SB/SE Examination, and Director, International Individual Compliance, for all OVDP Examiners, *Use of Discretion on 2009 OVDP Cases* (Mar. 1, 2011).

assumed the violation was subject to the maximum penalty for willful violations unless the taxpayer could prove that the violation was not willful.<sup>22</sup> Thus, in the absence of evidence, taxpayers who would be subject to the lower penalty for non-willful violations (or given a warning letter or overlooked) outside of the program would be subject to the 20 percent penalty inside the program. Moreover, the IRS did not provide any guidance to taxpayers regarding what evidence they could use to establish non-willfulness or reasonable cause.

### What is the problem?

The IRS materially changed the terms of the 2009 OVDP after taxpayers applied to it in reliance on the original terms, treating similarly situated taxpayers differently.

Some taxpayers applied to the OVDP with the reasonable expectation, based on FAQ #35, that they could do no worse inside the program than they would fare in an audit. For those whose applications the IRS processed before March 1, this belief was mostly true.<sup>23</sup> For those whose applications the IRS processed after March 1, it was not. In other words, among similarly situated taxpayers who timely entered the 2009 OVDP, those whose cases were processed before March 1 could get a better deal than those whose cases were, through no fault of their own, processed after March 1. Such inconsistent treatment is simply unfair and arbitrary.

Those unlucky taxpayers who believed they should pay less under existing statutes and whose applications the IRS had not processed by March 1 had two options. They could either agree to pay more than they thought they owed or "opt out" of the 2009 OVDP and face the possibility of excessive civil penalties and criminal prosecution. Both options were problematic.

Opting out would leave a taxpayer worse off than if he or she had not entered the OVDP. The taxpayer's return was much more likely to be audited than if he or she had made a "quiet" correction.<sup>24</sup> Even taxpayers who made quiet corrections and were audited would be better off because they would not have wasted the

<sup>22</sup> IRS response to TAS information request (Aug. 4, 2011) ("In most cases, reasonable cause was not considered since examiners could not make that decision during a certification. Since OVDP cases were certifications and not examinations, it was up to the taxpayer to provide information to substantiate a lower penalty. In cases where clear and convincing documentation was provided by the taxpayer penalties at less than the maximum may have been considered at the discretion of the field subject to concurrence of a Technical Advisor .... Without adequate substantiation, maximum penalties were used for the comparison to the offshore penalty").

<sup>23</sup> We understand that at least in some cases, the IRS did not shift the burden of proof until after March 1.

<sup>24</sup> IRS guidance indicates that it "will" examine anyone who withdraws from the 2009 OVDP or 2011 OVDI, though the scope of the examination and identity of the examiner will depend upon what an IRS committee decides. See Memorandum for Commissioner, LB&I Division and Commissioner, SB/SE Division, from Deputy Commissioner for Services and Enforcement, *Guidance for Opt Out and Removal of Taxpayers from the Civil Settlement Structure of the 2009 OVDP and the 2011 OVDI* (June 1, 2011).

resources necessary to apply to the OVDP and any audit would likely cover fewer years.<sup>25</sup> Encouraging taxpayers to opt out would also waste all of the resources already expended on the 2009 OVDP application by the IRS, as it plans to examine them anyway. In any future examination, the IRS is likely to request and review the items that were before the examiner processing the 2009 OVDP submission.<sup>26</sup>

The other option available to these unlucky taxpayers whose applications were not processed by March 1, *i.e.*, to remain in the program and pay more than they believed they owed under "existing statutes" — was even worse. Even inadvertently applying pressure to taxpayers who would otherwise pay less under existing statutes to pay more than they owe violates IRS policy along with most conceptions of fairness and due process. According to IRS policy:

An exaction by the United States Government, which is not based upon law, statutory or otherwise, is a taking of property without due process of law, in violation of the Fifth Amendment to the United States Constitution. Accordingly, a Service representative in his/her conclusions of fact or application of the law, shall hew to the law and the recognized standards of legal construction. It shall be his/her duty to determine the correct amount of the tax, with strict impartiality as between the taxpayer and the Government, and without favoritism or discrimination as between taxpayers.<sup>27</sup>

*The IRS's reversal could be subject to legal challenge.*

If a court determines that a taxpayer has reasonably relied on FAQ #35 to his or her detriment, it might require the IRS to follow FAQ #35. It could base this decision on the so-called "Accardi" doctrine or similar legal theories based on the "duty of consistency" or "equality of treatment."<sup>28</sup> Courts often acknowledge that taxpayers generally may not rely on the IRM or similar types of guidance.<sup>29</sup> Particularly where taxpayers have reasonably relied on IRS procedures, however, courts have required the IRS to follow its procedures

<sup>25</sup> Audits of those making quiet corrections would be likely to cover fewer years because, unlike those who applied to the OVDP, those making quiet corrections are less likely to have been asked to agree to extend the statutory period of limitations with respect to old years.

<sup>26</sup> This contradicted the portion of 2009 OVDP FAQ #35, which stated "[T]hese examiners [the OVDP examiners] will compare the 20 percent offshore penalty to the total penalties that would otherwise apply to a particular taxpayer."

<sup>27</sup> Policy Statement 4-7, IRM 1.2.13.1.5 (Feb. 23, 1960). Moreover, the IRS mission is to "provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with *integrity and fairness to all*." IRM 1.1.1.1 (Mar. 1, 2006) (emphasis added).

<sup>28</sup> The Accardi doctrine was originally based on an agency's failure to follow its regulations. See, e.g., *Shaughnessy v. United States ex rel Accardi*, 349 U.S. 280, 281 (1955); *Vitarelli v. Seaton*, 359 U.S. 535 (1959). As noted below, however, it has been extended to other guidance and procedures.

<sup>29</sup> See, e.g., *Avers v. Comm'r*, T.C. Memo. 1988-176.

to avoid inconsistent results.<sup>30</sup> For example, after the IRS issued press releases announcing changes to procedures in the IRM that would require its special agents to give partial Miranda warnings that were not constitutionally required, some courts relied on the Accardi doctrine to suppress evidence obtained by agents who failed to comply with the new procedures.<sup>31</sup> The Accardi doctrine was later limited to situations where taxpayers had detrimentally relied on the government's procedures.<sup>32</sup> As noted above, however, it appears that some taxpayers may, in fact, have detrimentally relied on FAQ #35, for example, by incurring significant fees to participate in the OVDP and agreeing to extend the period of limitations.

*The IRS did not publish the March 1 memo as required by law.*

The Freedom of Information Act (FOIA) requires the IRS to make available to the public all "administrative staff manuals and instructions to staff that affect a member of the public," unless an exemption applies.<sup>33</sup> Thus, the IRS's failure to make its March 1 memo available to the public appears to have violated the FOIA. Moreover, if an item is not properly published and the taxpayer is not otherwise given "timely" notice of it, it may not be "relied on, used, or cited" by the IRS against a taxpayer.<sup>34</sup> While giving taxpayers notice of the March 1 memo might address this problem, it may be difficult to argue that such notice is timely. Accordingly, the IRS's use of and reliance on the March 1 memo may constitute a second FOIA violation.

<sup>30</sup> For further discussion of the Accardi doctrine and related legal theories, see, e.g., Thomas W. Merrill, *The Accardi Principle*, 74 *Geo. Wash. L. Rev.* 569 (2005-2006); Joshua I. Schwartz, *The Irresistible Force Meets the Immovable Object: Estoppel Remedies for an Agency's Violation of Its Own Regulations or Other Misconduct*, 44 *Admin. L. Rev.* 653 (1992); Christopher M. Pietruszkiewicz, *Does the Internal Revenue Service have a Duty to Treat Similarly Situated Taxpayers Similarly?* 74 *U. Cin. L. Rev.* 531, 532-534 (2005). Even in the absence of written procedures, the IRS may have a duty of "equality of treatment" and "consistency," but these theories may require the taxpayer to prove competitive disadvantage or invidious discrimination. See, e.g., *Int'l Bus. Machines Corp. v. U.S.*, 343 F.2d 914 (Ct. Cl. 1965), cert. denied, 382 U.S. 1028 (1966) (IRS abused discretion in prospectively (not retroactively) revoking beneficial private ruling given to taxpayer's competitor while denying the taxpayer a similar ruling in the interim). Compare *Avers v. Comm'r*, TC Memo 1988-176 (tax shelter investor not entitled to settlement on terms offered to other shelter investors because the offers were in error and the taxpayer failed to prove discriminatory purpose); with *Sirbo Holdings, Inc. v. Comm'r*, 476 F.2d 981 (2nd Cir. 1973) (reasoning the IRS could not settle with one taxpayer while refusing to settle on the same terms with another similarly situated taxpayer without explanation).

<sup>31</sup> See, e.g., *United States v. Heffner*, 420 F.2d 809 (4th Cir. 1969) ("An agency of the government must scrupulously observe rules, regulations, or procedures which it has established. When it fails to do so, its action cannot stand and courts will strike it down.... It is of no significance that the procedures or instructions which the IRS has established are more generous than the Constitution requires.... Nor does it matter that these IRS instructions to Special Agents were not promulgated in something formally labeled a 'Regulation' or adopted with strict regard to the Administrative Procedure Act; the Accardi doctrine has a broader sweep.... The arbitrary character of such a departure is in no way ameliorated by the fact that the ignored procedure was enunciated as an instruction in a 'News Release.'") (internal citations omitted); *United States v. Leahey*, 434 F.2d 7 (1st Cir. 1970) (explaining its suppression of evidence obtained without following IRM procedures: "we have the two factors intersecting: (1) a general guideline, deliberately devised, aiming at accomplishing uniform conduct of officials which affects the post-offense conduct of citizens involved in a criminal investigation; and (2) an equally deliberate public announcement, made in response to inquiries, on which many taxpayers and their advisors could reasonably and expectably rely. Under these circumstances we hold that the agency had a duty to conform to its procedure, that citizens have a right to rely on conformance, and that the courts must enforce both the right and duty.");

<sup>32</sup> *United States v. Caceres*, 440 U.S. 741, 752-53 (1979).

<sup>33</sup> See 5 U.S.C. § 552(a)(2)(C). No exemptions appear to apply in this case.

<sup>34</sup> 5 U.S.C. § 552(a)(2) (flush). To invalidate the agency's action, however, a taxpayer would need to establish that he or she was adversely affected by a lack of publication or would have been able to pursue an alternative course of conduct. See *Zaharakis v. Heckler*, 7744 F.2d 711, 714 (9th Cir. 1984).

*The IRS reversal has damaged its credibility with practitioners and may reduce voluntary compliance along with participation in any future initiatives.*

People voluntarily comply with tax laws for a variety of reasons other than economic deterrence.<sup>35</sup> According to one study, research "clearly shows that financial incentive, as well as the risk of detection and punishment, is less important than the influence of norms and moral values."<sup>36</sup> For example, a taxpayer who values integrity, honesty, and the benefits of government may feel guilty if he or she violates the rules. The strength of these motives may depend on whether the taxpayer perceives that the government or the IRS is acting with respect for basic elements of procedural justice such as impartiality, honesty, fairness, politeness, and respect for taxpayer rights.<sup>37</sup> The IRS generally acknowledges that such perceptions drive compliance.<sup>38</sup> Thus, the perception that the IRS is acting unfairly by treating similarly situated taxpayers differently and changing the terms of the OVDP after taxpayers have acted in reliance on them is likely to reduce respect for the IRS as well as voluntary compliance.

Perhaps even more importantly, many respected tax practitioners who undoubtedly play a significant role in facilitating tax compliance (or noncompliance) by their clients<sup>39</sup> have lost faith in the fairness and integrity of the IRS because of its reversal.<sup>40</sup> As a result, the IRS is likely to have more difficulty gaining participation in any future settlement initiatives.<sup>41</sup>

<sup>35</sup> See, e.g., National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 138-50 (Marjorie E. Kornhauser, *Normative and Cognitive Aspects of Tax Compliance*) (summarizing existing literature); IRS Oversight Board, 2009 Taxpayer Attitudes Survey (Feb. 2010) (finding 92 percent of survey respondents indicated that personal integrity influences their tax compliance behavior whereas only 63 percent cited the fear of an audit.).

<sup>36</sup> See, e.g., Swedish Tax Agency, *Right from the Start: Research and Strategies* 6 (2005).

<sup>37</sup> See, e.g., Michael Doran, *Tax Penalties and Tax Compliance*, 46 Harv. J. on Legis. 111, 113 (Winter 2009) (summarizing norms theories).

<sup>38</sup> According to the IRS policy statement, "[p]enalties are used to enhance voluntary compliance.... the Service will design, administer, and evaluate penalty programs based on how those programs can most efficiently encourage voluntary compliance." Policy Statement 20-1 (June 29, 2004). As the "penalty handbook" explains, "[p]enalties best aid voluntary compliance if they support belief in the fairness and effectiveness of the tax system." IRM 20.1.1.2(10) (Dec. 11, 2009). It acknowledges that disproportionately large or seemingly unfair penalties may discourage voluntary compliance. IRM 4.26.16.4 (July 1, 2008) (noting that the penalties for failure to file the required Report of Foreign Bank and Financial Accounts (FBAR) "should be asserted only to promote compliance with the FBAR.... examiners should consider whether the issuance of a warning letter and the securing of delinquent FBARS, rather than the assertion of a penalty, will achieve the desired result of improving compliance in the future.... Discretion is necessary because the total amount of penalties that can be applied under the statute can greatly exceed an amount that would be appropriate in view of the violation."); IRM 20.1.1.1.3 (Dec. 11, 2009) ("[a] wrong [penalty] decision, even though eventually corrected, has a negative impact on voluntary compliance." ).

<sup>39</sup> For a discussion of the role of preparers and their potential impact on tax compliance, see National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, at 44 (Leslie Book, *Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws*).

<sup>40</sup> See, e.g., CCH Federal Taxes Weekly, *Practitioners' Corner: Bar to Arguing Non-Willfulness Under Offshore Disclosure Programs Creates Concerns*, 2011 No. 13., 153, 155 (Mar. 31, 2011) (quoting Baker Hostetler tax partner, James Mastracchio, as saying: "We were able to make FAQ 35 submissions requesting a review of the willfulness issue all along until February 8 of this year ... [the IRS] seems to be changing the rules of the game halfway through.... It is clear that the IRS has been faced with a shortfall in administrative resources to review FAQ 35 submissions ... the troubling thing is that closing the program to willfulness consideration under FAQ 35 now, based on a resource issue, when some persons have been granted relief, treats similarly situated taxpayers differently."); Mark E. Matthews and Scott D. Michel, *IRS's Voluntary Disclosure Program for Offshore Accounts: A Critical Assessment After One Year*, 181 DTR J-1 (Sept. 21, 2010) (stating "from the viewpoint of the practitioner community perhaps more important, the FAQ 35 process now appears to be a classic "bait and switch." Practitioners advised clients that FAQ 35 would offer a chance at penalty mitigation, but now our experience is that the language in that guidance is essentially an empty promise."); Pedram Ben-Cohen, *IRS's Offshore Bait and Switch: The Case for FAQ 35*, 46 DTR J-1 (Mar. 9, 2011).

<sup>41</sup> According to the IRS, all of the 3,000 applications to the 2011 OVDI came in after the 2009 OVDP deadline and before the IRS's announcement of the 2011 OVDI on March 1, 2011. IRS response to TAS information request (July 13, 2011). Thus, it appears that the 2011 OVDI may not have received any significant number submissions after the IRS's reversal became known.

The IRS's reversal could also make taxpayers and practitioners generally less willing to trust and cooperate with the IRS in other situations.

### III. CONCLUSION

The 2009 OVDP was a great deal for people involved in criminal tax evasion. They were not affected by the IRS's "clarification" that it would not consider non-willfulness, reasonable cause, or the mitigation guidelines in applying the offshore penalty because their violations were willful. However, the IRS is perceived as having reneged on the terms of the 2009 OVDP that would benefit taxpayers whose violations were not willful. Many felt the IRS treated them unfairly as compared to similarly situated taxpayers. It placed them in the unacceptable position of having to agree to pay amounts they do not owe under "existing statutes" or face the prospect that the IRS would assert excessive civil and criminal penalties.

The IRS's perceived reversal burdened taxpayers, wasted resources, violated longstanding IRS policy, opened the IRS to potential legal challenges, and was not properly disclosed as required by FOIA. It also damaged the IRS's credibility with taxpayers as well as the practitioner community. As a result, the IRS is likely to have more difficulty gaining participation in any future settlement initiatives. This erosion in trust for the IRS among taxpayers and practitioners is also likely to have a negative impact on IRS's mission and voluntary tax compliance more generally.

#### Attachment

National Taxpayer Advocate Fiscal Year 2012 Objectives Report to Congress 23-24 (*IRS's Inconsistency and Failure to Follow Its Published Guidance Damaged Its Credibility with Practitioners involved in the Voluntary Disclosure Program*).

#### cc:

Steven T. Miller, Deputy Commissioner, Services and Enforcement  
Douglas Shulman, Commissioner of Internal Revenue

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

AUG 30 2011

MEMORANDUM FOR STEVEN T. MILLER, DEPUTY COMMISSIONER  
FOR SERVICES AND ENFORCEMENT

FROM: Heather C. Maloy  
Commissioner, Large Business and International Division  
Faris R. Fink  
Commissioner, Small Business/Self-Employed Division

SUBJECT: Appeal of Taxpayer Advocate Directive 2011-1 (Implement 2009 Offshore Voluntary  
Disclosure Program FAQ #35 and comply with the Freedom of Information Act)

In accordance with IRM 13.2.1.6.2 (TAD Appeal [Process]), we appeal the above- referenced  
Taxpayer Advocate Directive (TAD), dated August 16, 2011. The TAD directed us to take  
certain actions within 15 business days. The actions were described as follows in the TAD:

1. Disclose the March 1, 2011, memo for Offshore Voluntary Disclosure Initiative (OVDI) Examiners that addresses the use of discretion in 2009 Offshore Voluntary Disclosure Program (OVDP) cases (the "March 1 memo") on [RS.gov, as required by the Freedom of Information Act (FOIA) (whether or not it is revoked).
2. Revoke the March 1 memo and disclose such revocation as required by FOIA.
3. Immediately direct all examiners that when determining whether a taxpayer would be liable for less than the "offshore penalty" under "existing statutes," as required by 2009 OVDP FAQ #35 (described below), they should not assume the violation was willful unless the taxpayer proves it was not. Direct them to use standard examination procedures to determine whether a taxpayer would be liable for a lesser amount under existing statutes (e.g., because the taxpayer was eligible for (a) the reasonable cause exception, (b) a non-willful penalty because the IRS lacked evidence to establish its burden to prove willfulness, or (c) application of the mitigation guidelines set forth in the [RM) without shifting the burden of proof onto the taxpayer. Post any such guidance on IRS.gov.
4. Commit to replace the March 1 memo and all OVD-related frequently asked questions (FAQs) on IRS.gov with guidance published in the Internal Revenue Bulletin, which describes the OVDP and OVDI. This guidance should incorporate comments from the public and internal stakeholders (including the National Taxpayer Advocate). It should reaffirm that taxpayers accepted into the 2009 OVDP will not be required to pay more than the amount for which they would otherwise be liable under existing statutes, as currently provided by 2009 OVDP FAQ #35. It should also direct OVDP examiners to

use standard examination procedures to make this determination, as provided in item #3 (above); and

5. Allow taxpayers who agreed to pay more under the 2009 OVDP than the amount for which they believe they would be liable under existing statutes the option to elect to have the IRS verify this claim (using standard examination procedures, as described above), and in cases where the IRS verifies it, offer to amend the closing agreement(s) to reduce the offshore penalty.

Regarding Action 1, we agree to disclose the March 1, 2011, memo on irs.gov.

We disagree with and appeal Actions 2, 3, 4, and 5. These actions are interrelated and substantively originate from a single issue - the application of FAQ 35.

The 2009 Offshore Voluntary Disclosure Program (OVDP) was designed to provide a way for taxpayers with previously undisclosed assets and unreported income to resolve their tax problems. The OVDP offered a uniform penalty structure that required taxpayers to pay either an accuracy-related or delinquency penalty and, in lieu of all other penalties that may apply, an offshore penalty equal to 20 percent of the amount in foreign bank accounts/entities in the year with the highest aggregate account asset value. Some of the penalties covered by the offshore penalty include: (1) a penalty for failing to file the Form TD F 90-22.1 (Report of Foreign Bank and Financial Accounts, commonly known as an "FBAR"); (2) a penalty for failing to file Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts; (3) a penalty for failing to file Form 3520-A, Information Return of Foreign Trust With a U.S. Owner; and (4) a penalty for failing to file Form 5471, Information Return of U.S. Person with Respect to Certain Foreign Corporations.

This provides taxpayers who made voluntary disclosures certainty regarding the resolution of their tax liabilities. If this resolution was not acceptable to a taxpayer, the taxpayer, in accordance with FAQ 35, could request that the case be referred for an examination of all relevant years and issues. The procedures that we have followed and the communications our examiners provided to taxpayers and their representatives clearly afforded the application of all examination procedures and appeal rights.

FAQ 35's answer states as follows:

"Voluntary disclosure examiners do not have discretion to settle cases for amounts less than what is properly due and owing. These examiners will compare the 20 percent offshore penalty to the total penalties that would otherwise apply to a particular taxpayer. Under no circumstances will a taxpayer be required to pay a penalty greater than what he would otherwise be liable for under existing statutes. If the taxpayer disagrees with the IRS's

determination, as set forth in the closing agreement, the taxpayer may request that the case be referred for a standard examination of all relevant years and issues. At the conclusion of this examination, all applicable penalties, including information return penalties and FBAR penalties, will be imposed. If, after the standard examination is concluded the case is closed unagreed, the taxpayer will have recourse to Appeals.”

The National Taxpayer Advocate asserts “total penalties that would otherwise apply” should refer to the total penalties that would be imposed after a standard examination. We disagree. The comparison should only involve issues that can be resolved using the information available during the certification of the voluntary disclosure. So, for example, if the period of limitations had run on the FBAR penalty for some of the years or the bulk of the offshore assets were not subject to the FBAR penalty, an agent could make a comparison that determined that the taxpayer’s liability under OVDP was higher than that under existing statutes and could give the taxpayer the benefit of the lower liability.

The mitigation standards are part of the Examination IRM. The National Taxpayer Advocate states that taxpayers believed that IRS would apply these mitigation standards in part because they were applied under the Last Chance Compliance Initiative (LCCI). This is not logical since the language of the 2009 OVDP FAQs was demonstrably different than the guidelines of the LCCI. Had the IRS intended to apply the mitigation standards in the course of the verification, we would have used the LCCI language and we would have required that taxpayers submit the necessary documentation with their application. We did neither of these things.

That an examination during the OVDP verification process is not contemplated as part of the OVDP is signaled by the OVDP procedures and numerous FAQs, including FAQ 35 itself when it says that “If the taxpayer disagrees with the IRS’s determination, as set forth in the closing agreement, the taxpayer may request that the case be referred for a standard examination of all relevant years and issues.” FAQ 28 provides that “if any part of the penalty framework is unacceptable to the taxpayer, the case will be examined and all applicable penalties may be imposed.” Similarly, FAQ 34 provides that “if any part of the penalty structure is unacceptable to a taxpayer, that case will follow the standard audit process. All relevant years and issues will be subject to a complete examination. At the conclusion of the examination, all applicable penalties (including information return and FBAR penalties) will be imposed.”

The OVDP process also signals that examinations will not be a part of the program in that taxpayers are not requested to submit information regarding their level of knowledge-information that would be needed during an examination that would have to consider such

things as whether a taxpayer had reasonable cause for failing to file an FBAR or whether a taxpayer was entitled to the FBAR mitigation provisions.

It therefore stands to reason that a taxpayer who filed a voluntary disclosure but believed he should owe less than the 20 percent offshore penalty should have expected that the route to that outcome would only come through a full examination, not solely through application of FAQ 35.

The Advocate claims that "opting out would leave a taxpayer worse off than if he or she had not entered the OVDP". We do not believe this assertion is based in fact and it is contrary to guidance issued by the Deputy Commissioner Services and Enforcement.

This guidance (Guidance for Opt Out and Removal of Taxpayers from the Civil Settlement Structure of the 2009 Offshore Voluntary Disclosure Program (2009 OVDP) and the 2011 Offshore Voluntary Disclosure Initiative (2011 OVDI) states "The procedures have been designed to balance the interests at stake, to ensure fairness and consistency for all taxpayers in the 2009 OVDP and 2011 OVDI and to allow for flexibility where necessary". Further, the guidance states "It should be recognized that in a given case, the opt out option may reflect a preferred approach. That is, there may be instances in which the results under the applicable voluntary disclosure program appear too severe given the facts of the case."

The Advocate claims that taxpayers would be subjected to the possibility of "excessive civil penalties and criminal prosecution". We disagree. First, taxpayers who opt out do not lose the criminal protections afforded through the disclosure. Instead, only "to the extent that issues are found upon a full scope examination that were not disclosed, those issues may be the subject of review by the Criminal Investigation Division. " Moreover, a full scope examination requires determinations that are based upon the facts and circumstances of the case. Examiners cannot arbitrarily assert penalties nor pursue criminal fraud without a meritorious argument. Examination outcomes also follow normal procedural remedies for disagreement in the form of Appeal rights.

In conclusion, for the reasons set forth above, we respectfully appeal Actions 2, 3, 4, and 5. We request that the Deputy Commissioner rescind this TAD in accordance with the authority vested in him by Delegation Order 13-3.



YOUR VOICE AT THE IRS



THE OFFICE OF THE TAXPAYER ADVOCATE OPERATES INDEPENDENTLY OF ANY OTHER IRS  
OFFICE AND REPORTS DIRECTLY TO CONGRESS THROUGH THE NATIONAL TAXPAYER ADVOCATE.

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Response Due:  
October 6, 2011

September 22, 2011

MEMORANDUM FOR STEVEN T. MILLER, DEPUTY COMMISSIONER,  
SERVICES AND ENFORCEMENT

FROM: Nina E. Olson  
National Taxpayer Advocate

SUBJECT: Appeal of Taxpayer Advocate Directive 2011-1 (Implement 2009 Offshore  
Voluntary Disclosure Program FAQ #35 and comply with the Freedom of  
Information Act)

On August 16, 2011, I issued Taxpayer Advocate Directive (TAD) 2011-1 (attached), which directed the IRS to take various actions to implement 2009 Offshore Voluntary Disclosure Program (OVDP) FAQ #35 and to release a March 1, 2011 memo, as required by the Freedom of Information Act (FOIA). On September 1, 2011, I received a copy of the TAD appeal signed by Faris Fink, Commissioner, Small Business/Self-Employed (SB/SE) Division and Heather C. Maloy, Commissioner, Large Business & International (LB&I) Division. SB/SE and LB&I agreed to release the memo, but did not agree to take the other four actions relating to the implementation of OVDP FAQ #35.

Part I of the discussion below summarizes our primary OVDP concerns. Part II addresses aspects of the TAD appeal not addressed in Part I. Part III concludes the discussion and restates the directives that remain unresolved.

**The IRS harmed taxpayers seeking to correct honest mistakes.**

One basic problem with the OVDP is that it assumes all participants are tax evaders hiding money overseas, when in fact, the IRS has steered many people into the program who made honest mistakes. Because of the uncertainty concerning the penalties that will apply

if they opt out, IRS procedures are pressuring many of them to pay more than they owe. The IRS Commissioner has stated that the purpose of the OVDP is to bring people back into the U.S. tax system.<sup>1</sup> Pressuring those who made honest mistakes to pay more than they owe is more likely to prompt taxpayers to avoid all contact with the IRS and the U.S. tax system in the future, rather than to come back into it.<sup>2</sup> It may also damage the IRS's credibility and reduce the effectiveness of any future initiatives. The following sections describe how this happened.

The IRS retroactively changed the terms of the OVDP. Where a person is required to file Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts (FBAR)*, and willfully fails to do so, the law authorizes a penalty up to the greater of \$100,000 or 50 percent of the balance of the undisclosed account each year.<sup>3</sup> Where the IRS cannot prove that the failure was willful, the law authorizes a penalty of up to \$10,000.<sup>4</sup> Finally, where a taxpayer can show that he or she had reasonable cause for failing to file an FBAR and the balance in the account is reported, the statute provides that "no penalty shall be imposed."<sup>5</sup>

Under the OVDP, a person is generally subject to a 20 percent "off-shore" penalty in lieu of various penalties that otherwise would apply, including the penalty for failure to file an FBAR.<sup>6</sup> However, OVDP FAQ #35 stated 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." This was an important statement that practitioners and taxpayers relied on.

Given the statutory provisions described above, it seemed clear to most practitioners and many IRS agents that the phrase "existing statutes" included those statutes that reduced the maximum FBAR penalty to \$10,000 for nonwillful violations and waived the penalty entirely in certain cases where the violation was due to reasonable cause. Thus,

<sup>1</sup> IR-2011-94, *IRS Shows Continued Progress on International Tax Evasion* (Sept. 15, 2011) (quoting the Commissioner as saying "[M]y goal all along was to get people back into the U.S. tax system").

<sup>2</sup> See Suzanne Steel, *Read Jim Flaherty's Letter on Americans in Canada*, Financial Post (Sept. 16, 2011), <http://business.financialpost.com/2011/09/16/read-jim-flahertys-letter-on-americans-in-canada/> (according to the Canadian Finance Minister "many U.S.-Canadian dual citizens are unaware of their obligations to file with the IRS.... most have paid taxes in Canada and have no tax liability in the United States, but still face the threat of prohibitive fines [under FBAR]... These are people who have made innocent errors of omission that deserve to be looked upon with leniency.... We support efforts to crack down on legitimate tax evasion. These measures, however, do not achieve that goal").

<sup>3</sup> 31 U.S.C. § 5321(a)(5).

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> Our discussion focuses on the FBAR penalty because it is often the largest and most disproportionate penalty involved.

FAQ #35 prompted many people whose violations were not willful to apply to the OVDP.

On March 1, 2011, however, more than a year after the 2009 OVDP ended, the IRS issued a memo (the "March 1 memo") suggesting it would no longer consider whether taxpayers would pay less under existing statutes, except in limited circumstances.<sup>7</sup> The March 1 memo is widely viewed as contradicting the IRS's statement in FAQ #35. The impression that the IRS has pulled a "bait and switch" in an important voluntary compliance initiative tarnishes the agency's image for transparency and fair dealing, undermines the public's willingness to trust the agency, may undermine its legal position if some of these cases proceed to litigation, and is likely to blunt the effectiveness of any voluntary compliance initiative that the IRS may offer in the future.

Without FAQ #35 the OVDP penalty structure assumes all participants are tax evaders hiding money overseas, when in fact, the IRS steered many people into the program who made honest mistakes. Without FAQ #35, OVDP attempts to apply a single set of rules to two very different populations — those whose violations were willful and those whose violations were not. This is a challenge that does not arise as frequently in other settlement initiatives. For example, a taxpayer is less likely to have "inadvertently" understated income with respect to a highly-structured tax shelter transaction that required advice from a sophisticated tax advisor than to have inadvertently failed to file an FBAR with respect to a seemingly innocuous foreign account. Thus, it makes more sense to have a single set of rules to address tax shelters than to address the failure to file an FBAR.<sup>8</sup>

We acknowledge that in the case of FBARs, there are "bad actors" whose sole or primary reason for establishing and maintaining unreported overseas accounts was to evade tax. Since these actors may be subject to civil penalties of up to 50 percent of the maximum account balance (or \$100,000, if greater) for each year of noncompliance plus

<sup>7</sup> The IRS did not initially release the memo to the public, as required by FOIA, but has now done so in response to the TAD. We commend the IRS for releasing the memo.

<sup>8</sup> Even in the case of tax shelters, however, it is easy to make the mistake of lumping everyone into the same bucket and then having to back-track. For example, when policymakers designed the one-size-fits-all strict liability penalty for failure to report a listed transaction under IRC § 6707A, they probably did not contemplate how disproportionate it could be for some. The penalty was originally \$100,000 for individuals and \$200,000 for entities, regardless of the amount of the decrease in tax shown on the return. In the National Taxpayer Advocate's 2008 Annual Report to Congress, we highlighted the unfair and extreme results this penalty could produce and recommended changes. Congress subsequently revised the penalty to be 75 percent of the decrease in tax resulting from the transaction in most cases. See Creating Small Business Jobs Act of 2010, Pub. L. No. 111-240, Title II, § 2041(a), 124 Stat. 2506, 2560 (2010).

the possibility of criminal penalties, the IRS's offer to apply a penalty of 20 percent of the maximum account balance for a single year seems lenient and provided a substantial incentive for them to disclose and pay.

By contrast, there are relatively "benign actors" whose primary reason for establishing and maintaining overseas accounts was unrelated to tax. Examples practitioners have provided include:

- residents of Canada or other foreign jurisdictions who were born in the U.S. while their parents were temporarily working or vacationing here and have dual citizenship, but who have never lived here and never filed tax returns here;
- people who inherited an overseas account or opened one to send money to friends or relatives abroad;<sup>9</sup>
- refugees from Iran when the Shah fell, or from other countries, who have felt compelled to conceal their assets out of concern that the countries from which they fled might pursue them; and
- Holocaust survivors and their children who are frightened that the Holocaust could happen again and feel safer spreading their assets around in case they are seized in one place or another.

In these circumstances and others, the IRS may be unable to prove willful noncompliance or may, indeed, be convinced that the non-compliance was not willful or that the taxpayer had reasonable cause. These taxpayers ordinarily would not be subject to an FBAR penalty, or if they were, it would generally not exceed \$10,000, particularly if the taxpayer voluntarily corrected the problem before being contacted by the IRS.

The IRS reversal treats some similarly-situated taxpayers who made honest mistakes differently than others. Among similarly situated taxpayers who inadvertently failed to file an FBAR and timely entered the OVDP, those whose cases the IRS processed before March 1, 2011, could get a better deal (paying less than the 20 percent offshore penalty) than those whose cases it processed later. As commentators have noted:

<sup>9</sup> We recognize that a special five-percent rate may apply to some of these taxpayers, but that exception is too narrow to apply in some sympathetic cases. OVDI FAQ #52.

*It would violate the principle of horizontal equity to apply a tougher standard to taxpayers in the 2009 [O]VDP simply because they have not yet closed their cases, compared to similarly situated taxpayers that have already settled their cases and obtained relief pursuant to FAQ 35. To permit such arbitrary and unfair outcomes for similarly situated taxpayers participating in the same program would severely undermine the foundational principles of our system of taxation and deter taxpayers from making voluntary disclosures in the future.<sup>10</sup>*

In our view, it violates fundamental notions of due process and fair dealing to give taxpayers whose cases the IRS happened to process earlier a better deal than those whose cases it happened to process later. This, too, will undermine public trust.

Even when making the FAQ #35 comparison, the IRS applies existing statutes inconsistently. Under existing statutes, the IRS bears the burden of proving that a person willfully violated a known legal duty before it may impose the penalty applicable to willful FBAR violations.<sup>11</sup> This is appropriate because "willfulness" is a common element that the government must prove in criminal cases, where the government always bears the burden of proof. In addition, because the existing statute specifies only a "maximum" FBAR penalty amount that the IRS "may" impose, the statute does not contemplate that the IRS would apply the maximum penalty for willful violations in every case. Some commentators have even suggested that doing so would be unconstitutional.<sup>12</sup> Accordingly, IRM 4.26.16 implements existing statutes by instructing employees to:

- issue warning letters in lieu of penalties,
- consider reasonable cause,
- assert the penalty for willful violations only if the IRS has proven willfulness,
- impose less than the maximum penalty for failure to report small accounts under "mitigation guidelines," and

<sup>10</sup> Pedram Ben-Cohen, *IRS's Offshore Bait and Switch: The Case for FAQ 35*, 46 DTR J-1 (Mar. 9, 2011).

<sup>11</sup> *Ratzlaf v. United States*, 510 U.S. 135 (1994); IRM 4.26.16.4.5.3 (July 1, 2008).

<sup>12</sup> See Steven Toscher and Barbara Lubin, *When Penalties Are Excessive – The Excessive Fines Clause as a Limitation on the Imposition of the Willful FBAR Penalty*, J. Tax Practice and Proc. (Dec. 2009 - Jan. 2010).

- apply multiple FBAR penalties only in the most egregious cases.<sup>13</sup>

Although the IRS did not have a nationwide checklist of information that it would request to determine what the FBAR penalty would be under existing statutes (e.g., whether the violation was willful) and whether these taxpayer-favorable IRM provisions applied, some revenue agents created their own checklists and routinely requested such information before the IRS issued the March 1 memo. Following the March 1 memo, however, the IRS has selectively applied these IRM provisions in cases where the IRS has made the FAQ #35 comparison. In some cases, it used the maximum willful FBAR penalty for comparison purposes unless the taxpayer had proved the violation was not willful.<sup>14</sup> Thus, it has turned the IRS's burden of proof on its head.

Based on our conversations with practitioners, we believe it is a wholly unrealistic to expect that taxpayers will risk massive civil and criminal penalties by opting out of the OVDP, even in the most sympathetic cases. On June 1, 2011, the Deputy Commissioner issued a memo (the "opt-out memo") that stated a "taxpayer should not be treated in a negative fashion merely because he or she chooses to opt out."<sup>15</sup> However, this direction was not incorporated into the OVDP FAQs because the memo was issued long after the OVDP ended. FAQ #34 states that for those who opt out:

*All relevant years and issues will be subject to a **complete examination**. At the conclusion of the examination, **all applicable penalties (including information return and FBAR penalties) will be imposed**. Those penalties could be substantially greater than the 20 percent penalty. [Emphasis added.]*

<sup>13</sup> IRM 4.26.16.4.4(2) (July 1, 2008) (reasonable cause); IRM 4.26.16.4.5.3 (July 1, 2008) ("The burden of establishing willfulness is on the Service."); IRM 4.26.16.4.7(3) (July 1, 2008) (warning letter in lieu of penalties); IRM Exhibit 4.26.16-2 (July 1, 2008) (mitigation guidelines); IRM 4.26.16.4.7 (July 1, 2008) ("the assertion of multiple [FBAR] penalties ... should be considered only in the most egregious cases.").

<sup>14</sup> IRS response to TAS information request (Aug. 4, 2011) ("In most cases, reasonable cause was not considered since examiners could not make that decision during a certification. Since OVDP cases were certifications and not examinations, it was up to the taxpayer to provide information to substantiate a lower penalty. In cases where clear and convincing documentation was provided by the taxpayer penalties at less than the maximum may have been considered at the discretion of the field subject to concurrence of a Technical Advisor .... Without adequate substantiation, maximum penalties were used for the comparison to the offshore penalty."). This critical aspect of the program was not included in the FAQs nor was it available to taxpayers or IRS employees in any written form. Moreover, it is contrary to the IRS's interpretation of the first sentence of FAQ #35 which states: "Voluntary disclosure examiners do not have discretion to settle cases for amounts less than what is properly due and owing." However, we believe the "discretion" language in the first sentence of FAQ #35 could be interpreted as clarifying that examiners would not have the authority traditionally delegated to Appeals officers to settle cases based on the "hazards of litigation." See, e.g., Policy Statement 8-47, IRM 1.2.17.1.6 (Aug. 28, 2007).

<sup>15</sup> See Memorandum for Commissioner, LB&I Division and Commissioner, SB/SE Division, from Deputy Commissioner for Services and Enforcement, Guidance for Opt Out and Removal of Taxpayers from the Civil Settlement Structure of the 2009 OVDP and the 2011 OVDP (June 1, 2011).

Most people would view a "complete examination" of all issues and years, and application of "all applicable penalties" as being treated in a "negative fashion." Moreover, the opt-out memo did not clearly state whether the taxpayer-favorable provisions of IRM 4.26.16 (described above) would apply or if the IRS would seek to impose the statutory maximums. Given this ambiguity and the IRS's seemingly arbitrary approach in applying "existing statutes" inside the OVDP, taxpayers and practitioners believe they will not be treated fairly if they opt out.

The IRS's decision to administer the OVDP using technical advisors and telephone assistants rather than by issuing written guidance that taxpayers and practitioners could rely upon has also created the impression that the IRS might arbitrarily assert civil and possibly even criminal FBAR penalties. Moreover, the opt-out memo warned that, "to the extent that issues are found upon a full scope examination that were not disclosed, those issues may be the subject of review by the Criminal Investigation Division." Furthermore, according to the New York State Bar Association (NYSBA),

*many revenue agents in the field have indicated that taxpayers who opt out of the voluntary disclosure programs will have a very difficult time convincing the Service not to impose maximum civil penalties. As a result, many taxpayers feel compelled to stay in the voluntary disclosure programs and accept inappropriately large penalties because they fear that if they opt out, they automatically will be assessed with huge information return penalties....<sup>16</sup>*

The IRS has been accepting these "inappropriately large" penalties in violation of FAQ #35 and its own policy to "determine the correct amount of the tax, with strict impartiality as between the taxpayer and the Government, and without favoritism or discrimination as between taxpayers."<sup>17</sup>

<sup>16</sup> Letter from NYSBA Tax Section to Commissioner, IRS, Chief Counsel, IRS, and Acting Assistant Secretary (Tax Policy) Department of the Treasury, 2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers, reprinted as, NYSBA Tax Section Comments on FAQ for 2011 Offshore Voluntary Disclosure Initiative, 2011 TNT 153-13 (Aug. 9, 2011) (hereinafter, "NYSBA Letter").

<sup>17</sup> Policy Statement 4-7, IRM 1.2.13.1.5 (Feb. 23, 1960).

The problem with the IRS's position that it will generally not consider willfulness or reasonable cause in the OVDP is that it proceeds from an assumption that all noncompliant actors should be treated as "bad actors" under the OVDP and that anyone who is a "benign actor" should opt out and go through the examination process. That assumption and the IRS's approach is misguided because practitioners have told us they would not advise taxpayers who have already come forward to take their chances with Exam.

Practitioners are not certain what standards the IRS will use to compute an appropriate penalty — as the IRS's shifting position within the OVDP has amply demonstrated, it may not adhere to its most recent nonbinding pronouncement — and the taxpayers would be assuming an enormous risk that the IRS could ultimately assert penalties of 50 percent of the maximum account balance for each year (which could bankrupt them) as well as criminal penalties. Particularly for those who reside abroad and naturally keep the majority of their assets in accounts where they live, this may represent nearly 50 percent of their net worth for each violation — 300 percent or more of their net worth over six years.

Even if the risk the IRS will take that position is remote, what practitioner would advise his client to assume that risk and what taxpayer would do so? Practitioners tell us that virtually no one would do so without further certainty about what rules will apply and what the result is likely to be if they opt out. Thus, while the IRS's assertion that anyone may request that his or her case go to Exam sounds logical, it is not currently viewed as a viable option. If the IRS refuses to consider nonwillfulness and reasonable cause within the OVDP, the practical result will be that the bad actors and the benign actors will both pay the same 20 percent penalty. That is not a fair or reasonable result.

In addition, according to the opt-out memo, the examination process will start over with a new examiner for taxpayers who opt out. Thus, if any are brave enough to opt out, the IRS's reinterpretation of FAQ #35 means they (and the IRS) will have wasted all of the resources in submitting and processing OVDP submissions.

**Why the initial IRS response does not address the problem.**

We appreciate the IRS's attempt to justify its approach in the TAD appeal. To the extent not already explained above, the following points describe why we respectfully disagree with the specific analysis contained in the TAD appeal.

The TAD appeal does not address the disparate treatment of similarly situated taxpayers (described above). Instead of addressing this central issue, the appeal focuses on how it was not reasonable for taxpayers, practitioners, IRS revenue agents, and the National Taxpayer Advocate to expect the IRS to determine what a taxpayer would "otherwise be liable for under existing statutes" in cases where the violation was not willful. Yet, the only reason the March 1 memo was necessary was because the IRS's own revenue agents interpreted FAQ #35 in accordance with its plain language.<sup>18</sup> Recently-published comments from key stakeholders emphasize the importance of this issue:

*Many taxpayers and practitioners interpreted this third modification [FAQ #35] to mean that the Service would consider whether a taxpayer should be subject to non-willful FBAR penalties as opposed to a 20% miscellaneous penalty...<sup>19</sup>*

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*We were able to make FAQ 35 submissions requesting a review of the willfulness issue all along until February 8 of this year ... [the IRS] seems to be changing the rules of the game halfway through.... the troubling thing is that closing the program to willfulness consideration under FAQ 35 now, based on a resource issue, when some persons have been granted relief, treats similarly situated taxpayers differently.<sup>20</sup>*

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[t]he FAQ 35 process now appears to be a classic 'bait and switch.' Practitioners advised clients that FAQ 35 would offer a chance at penalty mitigation, but now our experience is that the language in that guidance is essentially an empty promise.<sup>21</sup>

<sup>18</sup> According to IRS data, about 7,070 agreements had been signed as of May 20, 2011. IRS response to TAS information request (Sept. 14, 2011).

<sup>19</sup> NYSBA Letter.

<sup>20</sup> CCH Federal Taxes Weekly, *Practitioners' Corner: Bar to Arguing Non-Willfulness Under Offshore Disclosure Programs Creates Concerns*, 2011 No. 13, 153, 155 (Mar. 31, 2011).

<sup>21</sup> Mark E. Matthews and Scott D. Michel, *IRS's Voluntary Disclosure Program for Offshore Accounts: A Critical Assessment After One Year*, 181 DTR J-1 (Sept. 21, 2010).

Labeling the OVDP a "certification" had no bearing on whether the IRS would consider the willfulness of the violation in determining what a taxpayer would "otherwise be liable for under existing statutes." The TAD appeal suggests (on page 3) that the IRS's characterization of the 2009 OVDP as a "certification" rather than an "examination" provided a clear signal to the public that when doing the FAQ #35 comparison the IRS would assume that participants would otherwise be subject to FBAR penalties at the maximum statutory rate applicable willful violations.<sup>22</sup> It would have been illogical for the public to reach such a startling conclusion.

First, as an incentive to participate most settlement initiatives offer taxpayers a lower penalty than would otherwise apply. It makes sense for the IRS to give up penalties that might otherwise apply so that it can bring more taxpayers back into the U.S. tax system and improve future compliance. As noted above, that was the Commissioner's stated goal for the OVDP. Thus, it would have been illogical for people to assume that the IRS was offering a "deal" for taxpayers to pay more than they would have owed outside of the program. Moreover, in public statements, the IRS "strongly encouraged" nearly all taxpayers to participate.<sup>23</sup> It advised that the process was "appropriate for most taxpayers who have underreported their income with respect to offshore accounts,"<sup>24</sup> regardless of whether the IRS could prove the violation was willful. Thus, those whose violations the IRS could not prove were willful reasonably expected to receive some incentive to come forward. While FAQ #35 did not provide a clear incentive, it provided assurance they would not be worse off if they participated. The incentive for these taxpayers was a more rapid and certain resolution of the matter, but they would not have assumed such finality would come at the cost of paying more than they owed.<sup>25</sup>

<sup>22</sup> As noted above, under existing statutes the IRS would not have imposed such penalties except in the most "egregious" cases where it could meet its burden to prove that the violations were willful.

<sup>23</sup> FAQ #10.

<sup>24</sup> FAQ #50.

<sup>25</sup> Under the IRS's interpretation of FAQ #35, many of those who made inadvertent errors are worse off under the initiative. For example, a taxpayer who has expended the time and resources to apply, responded to IRS information requests, agreed to extend the period of limitations on assessment of FBAR penalties, waited for the IRS to process the OVDP application, is now expected to opt out and be subject to "a complete examination" of all issues and years. He or she will then be subject to "all applicable penalties." A taxpayer in this situation is worse off than if he or she had simply started complying with the FBAR requirements in 2009. Such a taxpayer avoided the time and expense of participating in the OVDP. The FBAR statute of limitations, which continues to run whether or not a return is filed, will have expired on all but the most recent six years. The IRS is unlikely to detect any violations, and if it does, the taxpayer is unlikely to be subject to any significant FBAR penalty because the IRS cannot prove that the violation was willful. Moreover, if the IRS follows its IRM, it is likely to issue a warning letter in lieu of a penalty or to assert an FBAR penalty only with respect to a single violation. In 2010, the government closed only 2,386 FBAR examinations, assessed less than \$41 million in FBAR penalties, referred a negligible number (too few to list) to DOJ for collection, initiated only 21 criminal investigations, and convicted only 7 people for willful FBAR violations. IRS response to TAS information request (Sept. 14, 2011). By contrast, it issued 131 warning letters in lieu of penalties. *Id.*

Second, the IRS can determine whether a willful or non-willful penalty applies under "existing statutes" (in accordance with the IRM provisions described above) using a certification process. Indeed, some examiners identified and requested the information they needed to make this determination from OVDP participants who were obligated to cooperate.<sup>26</sup> Moreover, some applied the taxpayer-favorable provisions of the IRM, which implements existing statutes (as described above).

Finally, the IRS did not ignore willfulness considerations, reverse the burden of proof, or ignore the taxpayer-favorable sections of the IRM when administering the predecessor of the OVDP (called the Last Chance Compliance Initiative or LCCI).<sup>27</sup> Like the OVDP, the LCCI did not involve an "examination."<sup>28</sup> Thus, the mere characterization of the process as a "certification" rather than an "examination" did not put the public on notice that the IRS would ignore the taxpayer-favorable provisions of the IRM or that it would assume all violations were willful.

The TAD appeal does not effectively distinguish the LCCI where it followed the IRM (e.g., by applying mitigation guidelines and considering willfulness) from the OVDP where it did not. The TAD appeal suggests (on page 3) that taxpayers should have known that the IRS would not consider willfulness, reasonable cause, and the mitigation guidelines because it did not require that taxpayers submit information addressing these issues when applying to the OVDP. However, the IRS did not request such information from those applying to the LCCI.<sup>29</sup> Rather, examiners could ask follow-up questions of participants who were obligated to cooperate.<sup>30</sup> It was reasonable for the IRS to do so in the OVDP as well.

<sup>26</sup> Similarly, OVDI FAQ #27 expressly provides that "the examiner has the right to ask any relevant questions, request any relevant documents, and even make third party contacts, if necessary to certify the accuracy of the amended returns, without converting the certification to an examination." Moreover, merely providing taxpayers the option to opt out if they disagree with the FAQ #35 comparison did not signal that the IRS would not actually do the comparison inside the OVDP, as the TAD appeal seems to suggest.

<sup>27</sup> See, e.g., Letter 3649 (Rev. 5-2006); Notice 1341 (Rev. 2-2007).

<sup>28</sup> *Id.*

<sup>29</sup> The IRS had a checklist of items that it requested as part of the LCCI. See, e.g., Letter 3649 (Rev. 5-2006); Notice 1341 (Rev. 2-2007). This checklist was somewhat different than the items taxpayers were to submit with OVDP applications. OVDI FAQ #21, #22; IRS, *Offshore Voluntary Disclosures – Optional Format* (Rev. 7-28-2009), available at <http://www.irs.gov/pub/foia/ig/ci/ltr-voluntary-disclosure-option-format-20090729.doc> (last visited Sept. 13, 2011). However, neither the LCCI nor the OVDP required taxpayers to submit items specifically addressing willfulness or non-willfulness.

<sup>30</sup> See, e.g., IRM 4.26.17.1 (May 5, 2008).

As noted above, some OVDP examiners developed their own checklists requesting follow-up information bearing on willfulness and reasonable cause. Thus, the content of the initial application package was not sufficient to lead taxpayers to doubt the unambiguous terms of OVDP FAQ #35. It did not lead the experienced practitioners quoted above or the IRS examiners who developed their own checklists to reach such a conclusion.

Moreover, under the OVDP the IRS urged taxpayers to include a schedule of the value of any unreported foreign accounts.<sup>31</sup> The value of these accounts is the primary information the IRS needs to apply the mitigation guidelines.<sup>32</sup> Thus, the items the IRS requested that taxpayers submit when applying to the LCCI and OVDP were not so significantly different as to alert the public that the IRS would follow the IRM in applying existing statutes under the LCCI but not the OVDP, particularly in light of OVDP FAQ #35.

### Conclusion

We commend the IRS for releasing the March 1 memo, as required by FOIA and the TAD. However, if the IRS does not consider willfulness or reasonable cause, or requires taxpayers to bear the burden of proving nonwillfulness, the benign actors will face a penalty inside the OVDP that is disproportionately harsh — and many are too frightened of the IRS and possible criminal or bankrupting civil penalties to opt out.

As noted above, this initiative is different from most previous initiatives involving tax shelters because it attracted both bad actors and benign actors who made honest mistakes. If the IRS had clearly communicated that everyone would be presumed to be a bad actor (or willful violator) as the TAD appeal asserts, it would not have attracted benign actors.

The IRS affirmatively attracted benign actors to the OVDP in two ways. First, it announced a method within the OVDP that would treat these differently situated taxpayers differently and fairly — by applying “existing statutes” to benign actors. Second, it threatened that bad things would happen to them outside of the program.<sup>33</sup> The fact that so many benign actors came in for what would be a terrible deal for them if they had understood the IRS’s intent (and

<sup>31</sup> See *id.*

<sup>32</sup> See IRM Exhibit 4.26.16-2 (July 1, 2008).

<sup>33</sup> See OVDP FAQ #3, #10, #12, #14, #15, #34, #49, #50.

were afraid to opt out) shows that the IRS did not clearly communicate what it meant to say.

Such miscommunication has consequences. If the government does not appear to treat benign actors fairly when they try to correct honest mistakes, then fewer people (even well-advised people) will try to correct their mistakes and voluntary compliance will suffer. Even if it were inclined to do so, the IRS does not have the resources to rely entirely on enforcement. It needs taxpayers to cooperate and comply voluntarily. While an estimated five million to seven million U.S. citizens reside abroad,<sup>34</sup> the IRS received only 218,840 FBAR filings in 2008.<sup>35</sup> By comparison, the government closed only 2,386 FBAR examinations and initiated only 21 criminal investigations in 2010.<sup>36</sup> While the OVDP attracted 15,364 applications, a more effective initiative would have prompted even more taxpayers to come into compliance without leaving those who did come forward feeling terrified, tricked, or cheated.<sup>37</sup> By generating such ill-will and mistrust, the IRS is squandering an opportunity to improve voluntary compliance.

Accordingly, we believe the IRS should create a fair process to evaluate willfulness, reasonable cause, etc. within the OVDP, with the proper burden of proof (on the IRS) as the public understood it to be doing at the outset.<sup>38</sup> Under that approach, the IRS will still have succeeded in bringing the accounts into the open, and collecting all back tax and interest and most penalties. The alternative, which is akin to a "guilty until proven innocent" approach, is not a good one for an agency of the United States government to follow.

More specifically, I continue to direct the IRS to take the following actions within **ten (10) business days**:

1. Revoke the March 1 memo and disclose such revocation as required by the Freedom of Information Act (FOIA).

<sup>34</sup> IRS web site, *Reaching Out to Americans Abroad* (Apr. 2009), <http://www.irs.gov/businesses/article/0,,id=205889,00.html>; W&I Research Study Report, *Understanding the International Taxpayer Experience: Service Awareness, Use, Preferences, and Filing Behaviors* (Feb. 2010) (citing U.S. Department of State data). This number does not include U.S. troops stationed abroad.

<sup>35</sup> National Taxpayer Advocate, 2009 Annual Report to Congress 144 (Most Serious Problem: *U.S. Taxpayers Located or Conducting Business Abroad Face Compliance Challenges*).

<sup>36</sup> IRS response to TAS information request (Sept. 14, 2011).

<sup>37</sup> IRS response to TAS information request (Sept. 14, 2011).

<sup>38</sup> A former federal prosecutor involved in the UBS case apparently agrees. See Jeffrey A. Neiman, *Opting Out: The Solution for the Non-Willful OVDI Taxpayer*, 2011 TNT 176-6 (Sept. 7, 2011) ("While the IRS does not have unlimited resources, an expedited review process could have been established to compare the facts and circumstances of an individual taxpayer's overseas account to a set of predetermined objective factors that would have allowed the IRS to assess a reasonable and fair FBAR-related penalty and avoided higher penalties for non-willful taxpayers.").

2. Immediately direct all examiners to follow FAQ #35 by not requiring a taxpayer to pay a penalty greater than what he or she would otherwise be liable for under "existing statutes." This direction should clarify that examiners should apply "existing statutes" in the same manner that the IRS applies them outside of the OVDP (*e.g.*, IRM 4.26.16 implements existing statutes by instructing employees to: issue warning letters in lieu of penalties, consider reasonable cause, assert the penalty for willful violations only if the IRS has proven willfulness, impose less than the maximum penalty for failure to report small accounts under "mitigation guidelines," and apply multiple FBAR penalties only in the most egregious cases).<sup>39</sup> Post any such guidance in the electronic reading room on IRS.gov as required by FOIA.
3. Commit to replace all OVD-related frequently asked questions (FAQs) on IRS.gov with guidance published in the Internal Revenue Bulletin, which describes the OVDP and OVDI.<sup>40</sup> This guidance should incorporate comments from the public and internal stakeholders (including the National Taxpayer Advocate). It should reaffirm that taxpayers accepted into the 2009 OVDP will not be required to pay more than the amount for which they would otherwise be liable under existing statutes, as currently provided by 2009 OVDP FAQ #35. It should also direct OVDP examiners to use the taxpayer-favorable provisions of the IRM (described above) to make this determination.
4. Allow taxpayers who agreed to pay more under the 2009 OVDP than the amount for which they believe they would be liable under existing statutes (as implemented by the IRS outside of the OVDP, and described above) the option to elect to have the IRS certify this claim, and offer to amend the closing agreement(s) to reduce the offshore penalty.<sup>41</sup>

<sup>39</sup> OVDI FAQ #27 already provides that "the examiner has the right to ask any relevant questions, request any relevant documents, and even make third-party contacts, if necessary to certify the accuracy of the amended returns, without converting the certification to an examination."

<sup>40</sup> This directive is consistent with recent comments from external stakeholders. See, *e.g.*, Letter from New York State Bar Association Tax Section to Commissioner, IRS, Chief Counsel, IRS, and Acting Assistant Secretary (Tax Policy) Department of the Treasury, *2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers*, reprinted as, NYSBA Tax Section Comments on FAQ for 2011 Offshore Voluntary Disclosure Initiative, 2011 TNT 153-13 (Aug. 9, 2011) (recommending public guidance). Moreover, settlement initiatives are often published in the Internal Revenue Bulletin. See, *e.g.*, Rev. Proc. 2003-11, 2003-1 C.B. 311 (Offshore Voluntary Compliance Initiative (OVCI)); Ann. 2004-46, 2004-1 C.B. 964 ("Son-of-Boss" settlement initiative).

<sup>41</sup> The IRS is already offering to amend 2009 OVDP agreements for taxpayers who would qualify for the reduced 5 percent or 12.5 percent offshore penalty rates under the 2011 OVDI. See OVDI FAQ #52; OVDI FAQ #53.

## Attachment

Taxpayer Advocate Directive 2011-1 (Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and comply with the Freedom of Information Act)

## cc:

Douglas Shulman, Commissioner of Internal Revenue

William J. Wilkins, Chief Counsel

Heather C. Maloy, Commissioner, Large Business and International Division

Faris Fink, Commissioner, Small Business/Self-Employed Division

Nikole Flax, Assistant Deputy Commissioner, Services and Enforcement

Jennifer Best, Special Assistant to the Commissioner

Ken Drexler, Senior Advisor to the National Taxpayer Advocate

Eric LoPresti, Senior Attorney Advisor to the National Taxpayer Advocate

Rosty Shiller, Attorney-Advisor to the National Taxpayer Advocate

Judy Wall, Special Counsel to the National Taxpayer Advocate



DEPUTY COMMISSIONER

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

October 14, 2011

MEMORANDUM FOR NINA E. OLSON, NATIONAL TAXPAYER ADVOCATE

FROM: ~~Steven T. Miller~~  
Deputy Commissioner for Services and Enforcement

SUBJECT: Taxpayer Advocate Directive 2011-1

Pursuant to Delegation Order No. 13-3, which grants the Deputy Commissioner the authority to modify or rescind any form of Taxpayer Advocate Directive, this memorandum sets forth the agreements to and rescissions of Taxpayer Advocate Directive (TAD) 2011-1.<sup>1</sup>

**Background**

On August 16, 2011, the National Taxpayer Advocate issued TAD 2011-1 to the Commissioner, Large Business & International Division, and the Commissioner, Small Business/Self-Employed Division to:

1. Disclose the March 1, 2011, memo for Offshore Voluntary Disclosure Initiative (OVDI) Examiners that addresses the use of discretion in 2009 Offshore Voluntary Disclosure Program (OVDP) cases (the "March 1 memo") on IRS.gov, as required by the Freedom of Information Act (FOIA) (whether or not it is revoked).
2. Revoke the March 1, 2011, memo and disclose such revocation as required by FOIA.
3. Immediately direct all examiners that when determining whether a taxpayer would be liable for less than the "offshore penalty" under "existing statutes," as required by 2009 OVDP FAQ #35 (described below), they should not assume the violation was willful unless the taxpayer proves it was not. Direct them to use standard examination procedures to determine whether a taxpayer would be liable for a lesser amount under existing statutes (e.g., because the taxpayer was eligible for (a) the reasonable cause exception, (b) a non-willful penalty because the IRS lacked evidence to establish its burden to prove willfulness, or (c) application of the mitigation guidelines set forth in the IRM) without shifting the burden of proof onto the taxpayer. Post any such guidance on IRS.gov.

<sup>1</sup> See Internal Revenue Manual (IRM) 1.2.50.4, Delegation Order 13-3 (formerly DO-250, Rev.1), *Authority to Issue Taxpayer Directives* (Jan. 17, 2001). See also IRM 13.2.1.6.1 *Tax Appeal Process*.

2

4. Commit to replace the March 1, 2011, memo and all OVD-related frequently asked questions (FAQs) on IRS.gov with guidance published in the Internal Revenue Bulletin, which describes the OVDP and OVDI. This guidance should incorporate comments from the public and internal stakeholders (including the National Taxpayer Advocate). It should reaffirm that taxpayers accepted into the 2009 OVDP will not be required to pay more than the amount for which they would otherwise be liable under existing statutes, as currently provided by 2009 OVDP FAQ #35. It should also direct OVDP examiners to use standard examination procedures to make this determination, as provided in item #3 (above); and
5. Allow taxpayers who agreed to pay more under the 2009 OVDP than the amount for which they believe they would be liable under existing statutes the option to elect to have the IRS verify this claim (using standard examination procedures, as described above), and in cases where the IRS verifies it, offer to amend the closing agreement(s) to reduce the offshore penalty.

#### **Appeal**

On August 30, 2011, TAD 2011-1 was appealed to me by to the Commissioner, Large Business & International Division, and the Commissioner, Small Business/Self-Employed Division.

#### **Agreement to and Rescission of TAD 2011-1**

I have had the opportunity to review and consider thoroughly the August 30, 2011, appeal and your rebuttal memorandum of September 22, 2011. Pursuant to Delegation Order No. 13-3, Taxpayer Advocate Directive (TAD) 2011-1 is agreed in part and rescinded in part. Action 1 of the TAD has been completed and is sustained. For the reasons stated in the August 30, 2011, appeal, actions 2-5 under the TAD are rescinded.

I believe that the relief you seek is generally provided in the existing opt out procedures. Throughout the entire program, taxpayers have had the opportunity to opt out of the settlement structure and request an examination if there is disagreement relating to the result provided for under the program. An examination is the appropriate forum for detailed facts and circumstances determinations. Moreover, the opt out procedures and additional guidance issued on June 1, 2011, clarify that, depending on the facts and circumstances, it may be preferable for a particular taxpayer to opt out of the 2009 OVDP or 2011 OVDI. The materials also provide guidance for taxpayers regarding the decision whether to opt out. Also clear in that guidance is that when appropriate, taxpayers will have the same agent for an examination following opt out.

cc: Heather C. Maloy  
Faris R. Fink

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

### OVERVIEW

The 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 tax law. For example:

- 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>1</sup>
- About a fifth of the U.S. population speaks a language other than English at home;<sup>2</sup> and
- The tax law applies to low income individuals, who make up 15.1 percent of the population.<sup>3</sup>

With a tax return for every couple of people, demographic trends create a question of whether there will continue to be an “average” taxpayer. Against a history of growing population and return volume, the number of returns per IRS employee generally has risen over the past century, while tax law complexity has increased along with automation.<sup>4</sup> Automation works for standard cases, but accommodating the various needs of a diverse taxpayer population has become a challenge for tax administration.

### DISCUSSION

#### Taxpayer Service Has Given Way to Mass Production

When the federal individual income tax was enacted in 1913, it applied to high-income taxpayers. At that time, the predecessor to the IRS began as a hands-on collector of various excise and other taxes. In 1942, Congress enacted the “greatest tax bill in American history” largely to fund the U.S. effort in World War II, expanding the income tax to the middle class.<sup>5</sup> At this juncture, the Treasury made an historic effort to popularize the income tax, and employed tactics such as famously deploying the Disney cartoon character Donald Duck as a mascot of the public fisc.<sup>6</sup> Since then, however, the IRS has not made a parallel effort to popularize the income tax to an increasingly diverse population.

<sup>1</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>2</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>3</sup> Census, *Income, Poverty and Health Insurance Coverage in the U.S.: 2010* (Sept. 13, 2011).

<sup>4</sup> Since World War II, however, the number of returns per IRS employee has remained relatively steady. See vol. 2, Research Study: *From Tax Collector to Fiscal Automaton: Demographic History of Federal Income Tax Administration, 1913-2011*, *infra*.

<sup>5</sup> See Randolph Paul, *TAXATION IN THE UNITED STATES* (BOSTON: Little, Brown & Co., 1954) 294-318.

<sup>6</sup> See Carolyn Jones, *Class Tax to Mass Tax: The Role of Propaganda in the Expansion of the Income Tax During World War II*, 37 *BUFF. L. REV.* 685 (1989).

In the second half of the last century, the tax system began to be automated. During the same period, women became a more significant taxpayer population.<sup>7</sup> In recent decades, a diverse low income population has become a significant customer base of an increasingly “faceless” IRS.

As set forth later under the subtitle “Demographic History of Federal Income Tax Administration, 1913-2011,”<sup>8</sup> the past century of income tax administration can be characterized as a transformation “From Tax Collector to Fiscal Automaton” because the IRS started as a revenue bureau but now administers social expenditures as well, through highly automated systems.<sup>9</sup> The National Taxpayer Advocate’s last two Annual Reports to Congress have examined aspects of this transformation. The 2009 Annual Report detailed the effects of social benefits administration, which in part involves a low income population.<sup>10</sup> Subsequently, the 2010 Annual Report proposed that the IRS adopt a dual mission statement, in part recognizing the diversity of its customer base.<sup>11</sup> More recently, the National Taxpayer Advocate’s mid-year report recommended “as a tax agency we deal with taxpayers as we find them, with all the vagaries of human existence, *i.e.*, ‘life in all its fullness.’”<sup>12</sup>

In the face of an historical trend toward automation, the National Taxpayer Advocate collaborated with the IRS and its Oversight Board in preparing a Taxpayer Assistance Blueprint in accordance with a 2005 congressional mandate.<sup>13</sup> While this document identifies IRS services of interest to taxpayers, it can be expanded in terms of its profile of taxpayer demographics to determine which services particular populations might need. Given a mission of customer service, it would be logical for the IRS to develop taxpayer profiles by pursuing market segment research, a widely accepted business practice.<sup>14</sup>

### Taxpayers Represent Diverse Demographics

Individual taxpayers are a subset of the U.S. population, characterized by diverse demographic groups. Individual taxpayers filed 141.2 million returns in 2010,<sup>15</sup> when there were

<sup>7</sup> See Edw. McCaffery, *TAXING WOMEN* (Univ. of Chicago Press, 1997).

<sup>8</sup> See vol. 2, Research Study: “*From Tax Collector to Fiscal Automaton: Demographic History of Federal Income Tax Administration, 1913-2011*,” *infra*.

<sup>9</sup> As a leading tax official put it in 1961: “With population growth and a broadened tax base, paperwork threatened to engulf tax administration. In self-defense, more and more attention had to be given to the development of means and methods for improving the processing of the paperwork. Invariably, a key element in this effort was the substitution of mechanical for manual methods of processing data.” Stanley S. Surrey, *Automatic Data Processing and Tax Administration: The Potentialities of ADP & Factors Involved in its Adoption*, *TAX POL’Y & TAX REFORM, 1961-1969: SELECTED SPEECHES & TESTIMONY*, ed. Wm. Hellmuth & Oliver Oldman (Chicago: Commerce Clearing House, 1973) 497-98.

<sup>10</sup> National Taxpayer Advocate 2009 Annual Report to Congress vol. 2 at 75 (Research Study: *Running Social Programs Through the Tax System*).

<sup>11</sup> National Taxpayer Advocate 2010 Annual Report to Congress 15 (Most Serious Problem: *The IRS Mission Statement Does Not Reflect the Agency’s Increasing Responsibilities for Administering Social Benefits Programs*); see also vol. 2 at 101 (Research Study: *Evaluate the Administration of Tax Expenditures*).

<sup>12</sup> National Taxpayer Advocate FY 2012 Objectives Report to Congress x; *Welch v. Helvering*, 290 U.S. 111, 115 (1933) (Cardozo, J.) (“The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle.”)

<sup>13</sup> IRS Pub. 4525, *The 2006 Taxpayer Assistance Blueprint*.

<sup>14</sup> See, e.g., Dennis Adcock, Al Halborg & Caroline Ross, *MARKETING: PRINCIPLES & PRACTICE* 4th ed. (Prentice Hall, 2001).

<sup>15</sup> IRS Pub. 55B, *Data Book* (2010) Table 2, Number of Returns Filed, by Type of Return, Fiscal Years 2009 and 2010, at 4.

308.7 million people in the United States according to the 2010 census.<sup>16</sup> With a tax return for about every two people, demographic trends are likely to have an impact on taxpayer service needs, and may fall into categories such as ethnicity, economics, gender, age, geography, and other characteristics.

### *Ethnic Groups*

About an eighth of the U.S. population is foreign-born,<sup>17</sup> about a fifth of the population speaks a language other than English at home, and 8.6 percent speak English less than “very well.”<sup>18</sup> Spanish is spoken in the homes of about 12 percent of the population.<sup>19</sup> According to the 2010 census, the Hispanic or Latino population is 16.3 percent of the country as a whole, while Asians make up 4.8 percent.<sup>20</sup> Consequently, English is not the vernacular for a significant number of taxpayers. As an economic matter, Hispanics are overrepresented in agricultural, construction, and maintenance occupations.<sup>21</sup>

The black or African-American population represents 12.6 percent of the U.S.<sup>22</sup> In combination, the American Indian, Alaska Native, Native Hawaiian, and other Pacific Islander population is more than one percent.<sup>23</sup> Historically, these populations have been concentrated in certain inner-city or rural communities which in turn may have characteristic needs, especially concerning media of communication.<sup>24</sup>

### *Economic Groups*

The U.S. population in poverty is 15.1 percent.<sup>25</sup> This population may be significant for tax provisions for low income taxpayers, like the Earned Income Tax Credit (EITC).<sup>26</sup>

In tax year (TY) 2008, 22.6 million sole proprietors owned businesses other than farming.<sup>27</sup> In calendar year (CY) 2007, 1.7 million farmers filed Schedule F, *Profit or Loss from Farming*, with the IRS.<sup>28</sup> In 2010, there were approximately 422,000 tax-exempt

<sup>16</sup> Census, *Population Distribution & Change: 2000 to 2010*, 2010 Census Brief (Mar. 2011).

<sup>17</sup> Census, 2005-09 AMER. COMM. SURVEY, Table S0501, *Selected Characteristics of the Native and Foreign-born Populations*.

<sup>18</sup> *Id.*

<sup>19</sup> Census, 2005-09 AMER. COMM. SURVEY, Table S1601, *Language Spoken at Home*.

<sup>20</sup> Census, *Overview of Race & Hispanic Origin*, 2010 Census Brief (Mar. 2011) Table 1 at 4.

<sup>21</sup> CENSUS, STATISTICAL ABSTRACT OF THE U.S. (2011) Table 36 at 40-41, *Selected Characteristics of Racial Groups & Hispanic Population: 2008*.

<sup>22</sup> Census, *Overview of Race & Hispanic Origin*, 2010 Census Brief (Mar. 2011) Table 1 at 4.

<sup>23</sup> *Id.*

<sup>24</sup> Census, *We the Americans: Blacks* (Sept. 1993) 3; Census, *We the People: American Indians and Alaska Natives in the U.S.* (Feb. 2006) 14; see also National Taxpayer Advocate 2008 Annual Report to Congress 95, 99-100 (Most Serious Problem: *Bringing Service to the Taxpayer*) (praising IRS outreach to Indian Tribal taxpayers).

<sup>25</sup> Census, *Income, Poverty and Health Insurance Coverage in the U.S.: 2010* (Sept. 13, 2011).

<sup>26</sup> IRC § 32.

<sup>27</sup> IRS Statistics of Income (Sol), Table 1, *Nonfarm Sole Proprietorships: Business Receipts, Selected Deductions, Payroll, & Net Income, by Indus. Sectors* (TY 2008), <http://www.irs.gov/taxstats/indtaxstats/article/0,,id=134481,00.html>.

<sup>28</sup> IRS Sol, Table 21, *Selected Returns & Forms Filed or to Be Filed by type During Specified CYs*, <http://www.irs.gov/taxstats/article/0,,id=175902,00.html>.

organizations with annual gross receipts under \$25,000.<sup>29</sup> These groups represent small businesses, including non-profit enterprises, that are the target of certain provisions, like the recently enacted health-care credit for small employers.<sup>30</sup>

Individuals who have low incomes or own small businesses represent disparate economic groups. In either case, they are taxpayers who may need particular assistance in complying with their tax requirements.

### *Gender-Related Groups*

In TY 2008, 37.7 percent of individual returns were filed jointly by married couples (including surviving spouses).<sup>31</sup> Consequently, over a third of individual taxpayers could fall into an “innocent spouse” situation. Historically, tens of thousands of taxpayers have filed Form 8857, *Request for Innocent Spouse Relief*, each year.<sup>32</sup>

More than five percent of U.S. households consist of unmarried partners; 4.9 percent are opposite-sex and 0.6 percent are same-sex partners.<sup>33</sup> While unmarried partners may share costs of living, they must segregate their income and expenses for tax purposes.

### *Other Populations*

The 2010 Census reports that 13 percent of the U.S. population is age 65 or over,<sup>34</sup> while earlier data show that 12 percent have a disability.<sup>35</sup> Seventy-nine percent of the U.S. population lives in urban areas, with 21 percent in rural areas.<sup>36</sup> Most of the former, or 68.3 percent of the population, are in central places within the urban areas.<sup>37</sup> For each of these groups, particular means of communication may be more effective than others.

### **Taxpayers Have a Typology of Needs**

Reviews of demographic characteristics of the population may indicate particular needs for taxpayer service, which in turn facilitates compliance with the tax law. Put another way, noncompliance may be averted by addressing tendencies where they arise in the taxpayer community. Which type of tax enforcement or service action will be most effective depends on whether the noncompliance is intentional (or purposeful), inadvertent, or

<sup>29</sup> Katie L. Roeger, *Small Nonprofit Organizations: A Profile of Form 990-N Filers*, Urban Inst. (Aug. 2010) Table 1 at 2.

<sup>30</sup> IRC § 45R.

<sup>31</sup> IRS Pub. 1304, *Individual Income Tax Returns* (2008) Table 1.6 at 75.

<sup>32</sup> National Taxpayer Advocate 2005 Annual Report to Congress 329 (Most Serious Problem: *Innocent Spouse Claims*); see also 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, infra*.

<sup>33</sup> Census, 2005-2009 AMER. COMM. SURVEY, Table S1101, *Households & Families*.

<sup>34</sup> Census, *Age & Sex Composition*, 2010 Census Brief (May 2011) Table 1 at 2.

<sup>35</sup> Census, 2009 AMER. COMM. SURVEY, *Selected Social Characteristics in the U.S.*

<sup>36</sup> Census, STATISTICAL ABSTRACT OF THE U.S. (2011) Table 29 at 36, *Urban & Rural Population by State: 2000*.

<sup>37</sup> Census, 2000 Summary File 1, Matrix P1, Table GCT-P1, *Urban/Rural & Metropolitan/Nonmetropolitan Population*; Census, *Urban and Rural Definitions* (Oct. 1995) (stating that an urban area “comprises one or more places (‘central place’) and the adjacent densely settled surrounding territory (‘urban fringe’) that together have a minimum of 50,000 persons”).

somewhere in between. To represent that spectrum or continuum of noncompliance, researchers have offered a typology of noncompliance encompassing eight types of behavior as follows.<sup>38</sup>

Even if noncompliance is intentional, distinguishing among five types of behavior may sharpen the response of the tax administrator. For “asocial” noncompliance motivated by economic gain, traditional deterrence measures that make the cost of noncompliance outweigh the benefit should mitigate this behavior. For “habitual” or knowing repetition of previous noncompliance, an effective enforcement action could break this cycle.

However, three other types of intentional noncompliance require more nuanced responses. For “symbolic” noncompliance due to a perception of the law or the IRS as unfair, enforcement could exacerbate the perception, while education (or even procedural or legislative change) could adjust it. For “social” noncompliance that accords with social norms or peer behavior, outreach to a whole community may be more effective than enforcement with respect to an individual whose reference group remains unchanged. Finally, “brokered” noncompliance mediated by professional advice is the most complex type of intentional behavior because it incorporates a third party, but by the same token, it offers the most leverage for the IRS, which can regulate tax return preparers.<sup>39</sup>

For inadvertent noncompliance, there are two types. “Unknowing” noncompliance is due to misunderstanding of rules, while “procedural” noncompliance is due to failure to follow complex processes, such as quarterly filing and tax deposit requirements. In both cases, education or procedural simplification may be the most effective response.

Between intentional and inadvertent noncompliance is “lazy” failure to follow burdensome requirements, such as recordkeeping. In this case, help may come from improved systems, an outstanding legislative example of which would be cost-basis reporting by brokers.<sup>40</sup>

Certain types of noncompliance may be characteristic of particular populations. For example, ethnic groups characterized by limited English proficiency and low income groups with literacy challenges may unknowingly miss substantive or procedural requirements.<sup>41</sup> Further, these populations may become dependent on tax preparers to translate English as well as “legalese.” In fact, EITC taxpayers are more likely than individual taxpayers in

<sup>38</sup> See Rob’t Kidder & Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance & Noncompliance*, 2 *TAXPAYER COMPLIANCE* 47 (1989); Leslie Book, *The Poor & Tax Compliance: One Size Does Not Fit All*, 5 *KANS. L. REV.* 1145 (2003).

<sup>39</sup> See IRS Pub. 4832, *Return Preparer Review* (Dec. 2009); National Taxpayer Advocate 2008 Annual Report to Congress 423 (Legislative Recommendation: *The Time Has Come to Regulate Federal Tax Return Preparers*).

<sup>40</sup> See IRC § 6045 as amended by Pub. L. No. 110-363 (2008); National Taxpayer Advocate 2005 Annual Report to Congress 433 (Legislative Recommendation: *Requiring Brokers to Track and Report Cost Basis for Stocks and Mutual Funds*).

<sup>41</sup> See Leslie Book, *The IRS’s EITC Compliance Regime: Taxpayers Caught in the Net*, 81 *ORE. L. REV.* 351, 393-405 (2002).

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

general to use preparers.<sup>42</sup> At the same time, recent immigrant populations may harbor a distrust of government, and may even perceive Volunteer Income Tax Assistance (VITA), a volunteer program sponsored by IRS, as an arm of the government.<sup>43</sup> Thus, “brokered noncompliance” also can become a factor for these groups.

For small businesses, “laziness” in recordkeeping (among other factors) can give rise to non-compliance.<sup>44</sup> Likewise, married or unmarried couples may not document their individual income and expenses when they share a household.<sup>45</sup>

Moreover, the tax law’s characterization of couples as either single or married may not adequately capture the economic reality of innocent spouses, domestic partners, persons of the opposite sex sharing living quarters, or inter-generational households. Because IRS programs and materials may not accurately characterize certain populations of taxpayers, they may not receive adequate tax treatment. For example, a Treasury Regulation requires a taxpayer who receives an information report on interest from a joint account to issue a Form 1099-INT, *Interest Income*, as to the joint owner, unless he or she is a spouse.<sup>46</sup> This regulation may be unrealistic for various types of joint owners, such as adult children who access accounts for elderly parents. Individuals who do not have the skills to file information returns may not find it worthwhile to acquire those skills only for a personal asset owned with another member of the household.

Finally, noncompliance by failure to pay may be characteristic of low income populations that historically have been racially marked. Blacks and Hispanics have been almost twice as likely as the general population to fall below the poverty level.<sup>47</sup> With respect to taxation, researchers have found that African-Americans and Hispanics are subject to enforcement actions (particularly liens) at double the rate of the general population.<sup>48</sup> Assuming that the IRS does not intend to discriminate, characteristic types of income or transactions may be more prevalent in particular populations.

For example, an academic analysis of census data has shown that “African-American households are more likely to pay a marriage penalty and White households are more likely to

<sup>42</sup> About two-thirds of tax returns claiming EITC benefits are completed by preparers rather than by the taxpayers themselves, while generally, 60 percent of individual taxpayers pay preparers. See IRS EITC Prep. Ofc., *EITC Summary of Vital Statistics* (May 2011); IRS Compliance Data Warehouse, *Individual Returns Transaction File* (TY 2008); Geo. Contos, John Guyton, Patrick Langetieg & Melissa Vigil, *Individual Taxpayer Compliance Burden: The Role of Assisted Methods in Taxpayer Response to Increasing Complexity* 7, IRS Research Conf. (June 2010).

<sup>43</sup> See 81 ORE. L. REV. at 401-402.

<sup>44</sup> Pres. Advisory Panel on Fed. Tax Reform, *Simple, Fair, & Pro-Growth: Proposals to Fix America’s Tax System* (Nov. 2005) 51 (“recordkeeping burdens and accounting rules are especially onerous for small businesses”).

<sup>45</sup> See Anthony Infanti, *The Internal Revenue Code as Sodomy Statute*, 44 STA. CLARA L. REV. 763 (2004).

<sup>46</sup> See Treas. Reg. § 1.6049-4(f)(4)(i).

<sup>47</sup> In 2010, 27.4 and 26.6 percent of Blacks and Hispanics, respectively, but only 15.1 percent of the whole population, were in poverty. See Census, *Income, Poverty and Health Insurance Coverage in the U.S.: 2010* (Sept. 13, 2011) Table B.

<sup>48</sup> *Blacks & Hispanics Face IRS Enforcement Actions at Double the Rate of General Population, Taxlifeboat Finds: Possible Discrimination Unintended Consequence of Automation & Increased Emphasis on Enforcement Rather than Services*, BUSINESS WIRE (Dec. 2, 2010).

receive a marriage bonus.”<sup>49</sup> This is because of “the significantly high percentage of African-American wives who contribute between 40 and 60 percent to total household income.”<sup>50</sup> Differential taxation follows from socio-economic characteristics of the population.

In any case, if inability to pay becomes an accepted pattern in economically downtrodden areas, it could become a form of social noncompliance, if not habitual for individuals. As TAS previously has reported, low income taxpayers need service in structuring payment plans even though they have relatively small liabilities.<sup>51</sup>

### Means of Communication May Exclude Distinct Populations.

In view of taxpayer demographics, there appears to be a significant population for whom English is a second language. Similarly, there are groups for which the Internet may be an ineffective means of communication. The medium or means of communication that the IRS uses to transmit information is crucial because tax administration depends on dissemination and collection of accurate information. Effective tax administration will use communication methods that taxpayers can understand.

Certain taxpayers whose first language is not English disproportionately use preparers.<sup>52</sup> This suggests that these taxpayers need preparers not only for tax advice but simply for translation, which would be consistent with the personal experience of TAS staff with un-enrolled but bilingual preparers. To the extent that the IRS does not translate tax forms or other information, taxpayers with limited English proficiency bear an extra cost to comply with their tax obligations.

Historically, the IRS has been able to leverage human resources through automation, modernizing through electronic communication. Nevertheless, statistics show that the Internet may not reach all populations. In particular, low income, less educated, minority, elderly, disabled, or rural populations are less likely than others to use the Internet as discussed below.

Only 40 percent of the population with income under \$30,000 has a broadband connection at home, compared to 87 percent of those with income of \$75,000 or more.<sup>53</sup> Similarly, 56 percent of low income Internet users have visited a government website at the local, state,

<sup>49</sup> See Dorothy A. Brown, *The Marriage Penalty/Bonus Debate: Legislative Issues in Black & White*, 16 N.Y.L. SCH. J. HUMAN RIGHTS 287 (1999).

<sup>50</sup> 16 N.Y.L. SCH. J. HUMAN RIGHTS at 294.

<sup>51</sup> See National Taxpayer Advocate 2006 Annual Report to Congress 141 (Most Serious Problem: *Collection Issues of Low Income Taxpayers*).

<sup>52</sup> See IRS, *Multilingual Initiative Customer Base Report* (FY 2006) 159, 214 (reporting that over 66 percent of low English proficiency survey respondents use a tax preparer (even though, with the exception of EITC claims, their relatively low incomes would indicate “simple” filing); 53 percent of Spanish speakers would have used a paid preparer if VITA services were not available compared to only 11 percent for English speakers). Overall, about 60 percent of individuals pay preparers. See IRS Compliance Data Warehouse, Individual Returns Transaction File (TY 2008); George Contos, John Guyton, Patrick Lange-tieg & Melissa Vigil, *Individual Taxpayer Compliance Burden: The Role of Assisted Methods in Taxpayer Response to Increasing Complexity 7* (presented at IRS Research Conference, June 2010).

<sup>53</sup> Jim Jansen, *Use of the Internet in Higher-Income Households*, Pew Research Ctr. (Nov. 24, 2010), Fig. 1 at 2.

or federal level, versus 79 percent of the high income group.<sup>54</sup> There is no Internet use at home for 67.8 percent of the population that did not graduate from high school, compared to only 25.3 percent for those who attended college.<sup>55</sup> In 2010, 56 percent of African-Americans were broadband users, compared to 67 percent of whites.<sup>56</sup> In 2009, only 31 percent of the population over age 72, and 56 percent of those from 64 to 72, were online, whereas 74 percent of all adults were online.<sup>57</sup> Only 41 percent of adults reporting certain disabilities have broadband at home, compared to 69 percent of those without a disability; similarly, 54 percent of disabled adults use the Internet, compared to 81 percent of other adults.<sup>58</sup> In 2010, half of rural adults subscribed to broadband at home, compared to 70 percent of non-rural adults.<sup>59</sup>

While information technology may be an inevitable sign of progress, modernization that neglects traditional means of communication, including face-to-face, paper, and telephone contact, may have the side effect of excluding distinct populations. No wonder that 56 percent of Americans believe that lack of broadband is a major or minor disadvantage when it comes to using government services, while only 37 percent think it is “not a disadvantage.”<sup>60</sup> As TAS previously recommended, demographic research is necessary to determine taxpayer needs, because “the IRS cannot forego offering services to groups of taxpayers who are difficult or costly to serve.”<sup>61</sup>

Moreover, mere access to home broadband does not guarantee skill at searching the Internet for tax rules, rights, or remedies. At the same time, some of the population without home broadband may be likely to use a land-line or cellular telephone instead.<sup>62</sup>

## SUMMARY

The IRS often does not address taxpayer needs by market segment because the problem of population dynamics is overarching while the IRS is organized around administration of particular provisions. Yet the discussion above shows a need to meet taxpayers where they are. Prior National Taxpayer Advocate reports to Congress suggested or offered a basis for

<sup>54</sup> *Use of the Internet in Higher-Income Households* 5.

<sup>55</sup> CENSUS, CURRENT POPULATION SURVEY (Oct. 2009), *Reported Internet Usage for Households by Selected Householder Characteristics*.

<sup>56</sup> Aaron Smith, *Home Broadband 2010*, Pew Research Ctr. (Aug. 11, 2010) 2.

<sup>57</sup> Sydney Jones & Susannah Fox, *Generations Online in 2009*, Pew Research Ctr. (Jan. 28, 2009) 5.

<sup>58</sup> Susannah Fox, *Americans Living with Disability & Their Technology Profile*, Pew Research Ctr. (Jan. 21, 2011) 3.

<sup>59</sup> *Home Broadband 2010*, 8.

<sup>60</sup> *Id.* at 3.

<sup>61</sup> National Taxpayer Advocate 2006 Annual Report to Congress vol. 2, 13 (*Study of Taxpayer Needs, Preferences, & Willingness to Use IRS Services*).

<sup>62</sup> See Forrester Research, Inc., *North American Technographics Benchmark Survey Q2/Q3, 2011* (U.S., Canada), July 2011 (indicating that about 70 percent of low-income individuals have a mobile telephone).

the following administrative and legislative recommendations to help address the needs of diverse populations:

1. **Translate Tax Forms for Identified Linguistic Groups.** Translate Form 656, *Offer in Compromise*, and the statutory notice of deficiency into Spanish, while reviewing needs of other linguistic groups for further translation.<sup>63</sup> As discussed above, the Spanish-speaking population overlaps with the low income population that needs help structuring payment of small liabilities. As TAS previously recommended, IRS documents that are “vital” for translation include any document that affects taxpayer rights, provides taxpayer protection, or proposes to assess a tax or levy on taxpayer property.<sup>64</sup> These documents include Form 12153, *Request for a Collection Due Process or Equivalent Hearing*. When various linguistic groups immigrate into the U.S., different translation needs may arise.
2. **Educate Small Businesses in Person as well as Online.** While the IRS has an excellent online Virtual Small Business Tax Workshop, this electronic presentation is unlikely to reach proprietors in populations with low Internet penetration.<sup>65</sup> As these proprietors may be engaged in the cash economy, targeted face-to-face workshops could be a worthy investment.<sup>66</sup>
3. **Conduct Targeted Outreach to Increase Take-up Rate for Special Tax Provisions.** Develop a pilot program to better communicate about special tax benefits in which participation is key, *e.g.*, health-care provisions under the Patient Protection and Affordable Care Act of 2010.<sup>67</sup> While the traditional mission of the IRS was to collect tax, now the IRS administers several special tax breaks that effectively disburse social benefits to target populations (*e.g.*, small businesses or low income taxpayers). A measure of success for such programs is their take-up rate, which means that the IRS must not only counsel compliance with the tax law but also encourage participation by taxpayers, many of whom may not otherwise have to file returns. This new outreach program, with front-line responsibility for the take-up rate, would dovetail with the dual mission statement for the IRS previously recommended by the National Taxpayer Advocate. A good example of outreach is a pilot program in which the IRS is collaborating with TAS to improve communication with EITC taxpayers.<sup>68</sup>
4. **Revise Guidance on Joint Property for Diverse Family Situations.** Revise guidance on joint or custodial accounts for benefit of elderly, disabled, or unmarried taxpayers. As discussed above, existing regulations may be unrealistic for a taxpayer who receives

<sup>63</sup> See IRM 4.8.9.8 (June 14, 2011) (describing notice of deficiency).

<sup>64</sup> National Taxpayer Advocate 2006 Annual Report to Congress 333 (Most Serious Problem: *Limited English Proficient (LEP) Taxpayers: Language & Cultural Barriers to Tax Compliance*).

<sup>65</sup> Pub. 1066-C.

<sup>66</sup> See National Taxpayer Advocate 2007 Annual Report to Congress 38 (Most Serious Problem: *The Cash Economy*) (“Although such education can be resource intensive, the IRS can leverage its resources by first using research to identify common small business errors that significantly contribute to the tax gap as well as those taxpayers who are most likely to make such errors and most likely to respond to workshops rather than other types of outreach”).

<sup>67</sup> Pub. L. No. 111-148.

<sup>68</sup> See National Taxpayer Advocate FY 2012 Objectives Report to Congress xxii.

an information return on income held jointly or custodially for another member of the household. Regulations should reflect the economic reality of a taxpayer's household. While household members other than spouses may not necessarily be recognized under the tax law, it should be possible to recognize certain classes by reference to state law, such as parents who are senior citizens, persons with disabilities, or registered domestic partners.<sup>69</sup>

5. **Allow Withholding for Economic Groups Not Incorporated into the Class of Wage Earners.** A previous TAS legislative recommendation would allow voluntary withholding for workers who are classified as independent contractors.<sup>70</sup> As discussed above, low income workers may become chronically unable to pay taxes, a situation that may be exacerbated if their employers classify them as contractors who are not subject to withholding. This classification may be a practice in certain industries, like agriculture, construction, and maintenance, in which certain populations, namely Hispanics, are disproportionately employed.<sup>71</sup> Voluntary withholding is a systematic mechanism that could remedy the problem (and eliminate some if not all of the incentive to misclassify such workers).<sup>72</sup>
6. **Expand the IRS Mission to Encompass Social Benefits Embedded in the Tax Law.** As previously recommended in connection with the dual mission statement, appoint a Deputy Commissioner for social benefits.<sup>73</sup> Pending appointment, undertake the following initiatives that ultimately will come under the new Deputy Commissioner:
  - Expand demographic analysis in the work of the IRS, and train more IRS personnel to use market segmentation techniques to paint useful portraits of taxpayer groups.
  - Update and expand the Taxpayer Assistance Blueprint regarding the needs and preferences of individuals as well as small enterprises, both for- and not-for-profit.<sup>74</sup>

<sup>69</sup> See National Taxpayer Advocate 2010 Annual Report to Congress 391 (Most Serious Problem: *State Domestic Partnership Laws Present Unanswered Federal Tax Questions*).

<sup>70</sup> National Taxpayer Advocate 2005 Annual Report to Congress 391 (Legislative Recommendation: *Measures to Reduce Noncompliance in the Cash Economy*).

<sup>71</sup> Steven F. Hipple, *Self-employment in the U.S.*, MONTHLY LABOR REV., U.S. Bur. of Labor Stats. (Sept. 2010) 17 ("self-employment continues to be more common . . . in the agriculture, construction, and services industries"); Census, STATISTICAL ABSTRACT OF THE U.S. (2011) Table 36 at 40-41, *Selected Characteristics of Racial Groups & Hispanic Population: 2008*.

<sup>72</sup> Another cash economy measure is S. 974, the Small Business Tax Equalization and Compliance bill (112th Cong.), which would extend the IRC § 45B credit for Social Security tax on cash tips now allowed in the restaurant industry to the cosmetology or beauty industry, with corresponding information reports.

<sup>73</sup> See National Taxpayer Advocate 2010 Annual Report to Congress 15 (Most Serious Problem: *The IRS Mission Statement Does Not Reflect the Agency's Increasing Responsibilities for Administering Social Benefits Programs*).

<sup>74</sup> See National Taxpayer Advocate 2006 Annual Report to Congress 172 (Most Serious Problem: *Small Business Outreach*) & vol. 2 (*Study of Taxpayers' Needs, Preferences, and Willingness to Use IRS Services*); National Taxpayer Advocate 2007 Annual Report to Congress 197 (Most Serious Problem: *Exempt Organization Outreach and Education*); National Taxpayer Advocate 2008 Annual Report to Congress 95 (Most Serious Problem: *Bringing Service to the Taxpayer*).

- Systematically analyze proposed or recently enacted legislation in terms of its target population to minimize burden and determine taxpayer service needs.<sup>75</sup>
- Form partnerships with agencies that have subject-matter expertise in relevant social programs, such as the Department of Health and Human Services.
- Evaluate the effectiveness of delivery of benefits and participation by eligible taxpayers as well as compliance.

With respect to diverse taxpayers, the Most Serious Problems described below are detailed in the following pages:

- Certain improvements in EITC service could enhance compliance as well as participation, which is essential for a provision that funds basic living expenses.
- Accelerated third-party reporting and pre-populated returns could address procedural and “lazy” noncompliance.
- Taxpayers who are victims of domestic violence and are kept in the dark at home about financial and tax matters need to be served by IRS employees trained to understand their circumstances.
- A telephone system for filing tax returns (TeleFile, as recommended by TAS last year), along with other demographically appropriate electronic preparation and filing options, could relieve the IRS from processing paper returns, even as distinct groups are unlikely to use the Internet.<sup>76</sup>

<sup>75</sup> See National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 75 (Research Study: *Running Social Programs Through the Tax System*); cf. National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 116 ff. (Research Study: *Evaluate the Administration of Tax Expenditures*).

<sup>76</sup> See National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 122 (Research Study: *TeleFile – Taxpayers’ Characteristics and Filing Behaviors: A Study to Enhance Taxpayer Assistance Blueprint Knowledge*).

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

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**DEFINITION OF PROBLEM**

Taxpayers face considerable compliance burdens and incur significant costs when preparing even simple tax returns. Much of the data needed for return preparation is supplied to the IRS by third-party reporting. This data remains unprocessed and unused for verification long after taxpayers file their returns and the IRS releases refunds. To reduce taxpayer burden, the IRS can follow the lead of other domestic and international tax agencies by enabling taxpayers to download third-party data directly into their return preparation software or even access a return pre-populated with such data. Both taxpayers and the IRS would benefit from the anticipated reduction in inadvertent noncompliance and the associated downstream costs.

While the benefits of incorporating information reporting data into the filing season are significant, concerns remain about the accuracy of the third-party data and the manner in which the IRS will make adjustments based on that data. Thus, before implementing accelerated information reporting, the IRS must develop procedures that provide taxpayers with the standard taxpayer rights that accrue during an examination, including adequate notice and an opportunity to contest the proposed adjustment administratively and in Tax Court.<sup>1</sup>

**ANALYSIS OF PROBLEM****Background - Third-Party Data Processing**

Forms *W-2*, *Wage and Tax Statement*, and most Forms 1099, *U.S. Information Return*, must be issued to the taxpayer by January 31. Under present law, issuers who file these forms electronically have another two months (until March 31) to file the forms with the government. Issuers send Forms 1099 directly to the IRS and Forms *W-2* directly to the Social Security Administration (SSA), which in turn sends information extracted from the forms to the IRS each week, starting in January.<sup>2</sup>

<sup>1</sup> 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*, *supra*.

<sup>2</sup> IRC §§ 6051(a), 6049(a), 6042(a); see IRS Instructions for Forms *W-2* and *W-3*, *Wage and Tax Statement and Transmittal of Wage and Tax Statements*; Social Security Administration, *Employer W-2 Filing Instructions & Information*, available at <http://www.ssa.gov/employer/gen.htm> (last visited Aug. 25, 2011); IRS, *Seven-Day Response to Most Serious Problem: Accelerated Third Party Info Reporting* (Nov. 17, 2011).

The IRS generally holds all third-party data until mid-May (after the filing season), when it downloads its Information Returns Master File (IRMF) database.<sup>3</sup> The IRS currently has initiatives studying the possibility of obtaining Form W-2 data from the SSA earlier to enable the IRS to match tax return data on potentially non-compliant returns by the third week in March.<sup>4</sup>

The IRS uses third-party reporting data to verify information reported on returns. The Automated Underreporter (AUR) program compares amounts shown on a taxpayer's return with third-party reports such as Forms W-2 and 1099s that have been uploaded to the IRMF.<sup>5</sup> For example, AUR matches wages shown on a Form W-2 with wages reported on a return, and interest shown on a Form 1099-INT, *Interest Income*, with interest reported on a return.<sup>6</sup>

### Compliance Rationale for Third-Party Reporting

Tax gap data illustrates that tax compliance is highest when IRS procedures make it simple. For example, withholding and third-party information reporting, which make it easier to report income and pay taxes, are key drivers of compliance.<sup>7</sup> Reporting compliance rates are about 99 percent on wages subject to withholding and third-party information reporting, about 96 percent on income subject to full third-party information reporting (*e.g.*, interest and dividends) — yet less than 50 percent on income not subject to third-party information reporting.<sup>8</sup> When a taxpayer receives a copy of an information reporting document showing income already reported by a third party to the IRS, the taxpayer expects the IRS to notice if the income is omitted from the return. Thus, “deterrence” likely accounts for some of these results.

Perhaps just as importantly, however, information reporting reduces one type of procedural burden — the complexity of determining what income should be reflected on the return. In addition, third-party reporting may facilitate recordkeeping for a taxpayer.<sup>9</sup> On the other hand, preparation of an information report is an incremental burden on the third party that has to prepare and file it. Because of the impact of reporting on compliance, Congress

<sup>3</sup> IRM 5.19.4.3.5(6).

<sup>4</sup> IRS, Overview of the Accelerated Refund Assurance Program (ARAP), Slide 8 (Oct. 6, 2011); IRS, PRP ESC, Slide 17 (July 25, 2011); IRS, Seven-Day Response to Most Serious Problem: *Accelerated Third Party Info Reporting* (Nov. 17, 2011).

<sup>5</sup> IRM 4.19.3.1.

<sup>6</sup> See National Taxpayer Advocate 2009 Annual Report to Congress 338-345.

<sup>7</sup> For additional discussion of the importance of third-party information reporting in prior testimony, see, *e.g.*, *The Tax Gap and Tax Shelters*, Hearing Before the Senate Comm. on Finance (July 21, 2004) (statement of Nina E. Olson, National Taxpayer Advocate); *The Causes of and Solutions to the Federal Tax Gap*, Hearing Before the Senate Comm. on the Budget (Feb. 15, 2006) (statement of Nina E. Olson, National Taxpayer Advocate); *The Tax Gap*, Hearing Before the Senate Subcomm. on Federal Financial Management, Government Information, and International Security Comm. on Homeland Security and Governmental Affairs (Sept. 26, 2006) (statement of Nina E. Olson, National Taxpayer Advocate); *The Causes of and Solutions to the Federal Tax Gap*, Hearing Before the Senate Comm. on the Budget (Feb. 15, 2006) (statement of Nina E. Olson, National Taxpayer Advocate); *The IRS and the Tax Gap*, Hearing Before the H. Comm. on the Budget (Feb. 16, 2007) (statement of Nina E. Olson, National Taxpayer Advocate).

<sup>8</sup> See IRS, Tax Gap Map for Year 2001 (Feb. 2007).

<sup>9</sup> Data show that information reporting dramatically increases the accuracy of taxpayer returns. See IRS, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance* 15 (Aug. 2, 2007).

over the years has required it where benefits of reporting outweigh the burdens on payers/reporters. However Congress has also repealed reporting where burden outweighs compliance benefits.<sup>10</sup>

### **Late Processing of Third-Party Data Harms Both Taxpayers and Tax Administration.**

The IRS receives and processes third-party data long after the taxpayer has filed the tax return and the IRS has released any associated refunds. The current system of “pay refunds first, verify later” harms taxpayers and undermines tax compliance. From a taxpayer perspective, the process leads to inadvertent overclaims that the IRS does not identify until months later, exposing the taxpayer to mounting penalties and interest. From a tax administration perspective, the system leads to payment of unwarranted refunds that the IRS must spend resources to recover. If the IRS processed third-party information returns before filing deadlines or, at the very latest, before the IRS releases refunds, it would spare taxpayers unnecessary assessment and collection action, stop more questionable claims, and collect more revenue.<sup>11</sup>

### **How the IRS Could Improve Taxpayer Electronic Access to Third-Party Information.**

Providing taxpayers with timely electronic access to third-party data will require the IRS to overhaul its current system of processing third-party reporting information and document matching. We propose the IRS evaluate the feasibility of taking the following steps:

#### *Expedite the Processing of Information Returns by Eliminating the Extra Month Provided to E-File and Imposing Stricter E-File Mandates.*

To provide taxpayers and the IRS with access to third-party data before the return filing deadline, the IRS must receive information returns earlier in the process. While the IRS should assess and consider the burden imposed on third-party reporters, it seems reasonable, given modern technology, to expect employers and financial institutions to be able to file reports with the government at the same time they issue them to employees and customers – on January 31.<sup>12</sup>

In addition to receiving the reports earlier, the IRS could process the information quicker if it received the returns electronically. The IRS currently encourages all third-party reporters

<sup>10</sup> Patient Protection and Affordable Care Act of 2010 would have required businesses to issue 1099 forms to other corporations from whom they purchased more than \$600 of goods and services in a single fiscal year. This was a significant expansion of the reporting requirements and was seen by many as a huge burden on businesses, particularly small businesses. On April 14, 2011, the Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011 was signed into law, repealing the reporting requirements. Pub. L. No. 112-9, 125 Stat. 36 (2011). See National Taxpayer Advocate 2010 Annual Report to Congress 373 (Legislative Recommendation: *Repeal Information Reporting on Purchases of Goods but Require Reporting on Corporate and Certain Other Payments*).

<sup>11</sup> See National Taxpayer Advocate 2009 Annual Report to Congress 338-345.

<sup>12</sup> Many countries have early filing deadlines for third-party reporting. See, OECD, *Using Third Party Information Reports to Assist Taxpayers Meet their Return Filing Obligations – Country Experiences With the Use of Pre-populated Personal Tax Returns* 19 (Mar. 2006), available at <http://www.oecd.org/dataoecd/42/14/36280368.pdf>; HM Revenue and Customs, *Key Tax Deadlines for Tax Agents 2011-2012*, available at <http://www.hmrc.gov.uk/transparency/other-data.htm>; Australia Office of Taxation, *PAYG withholding, NAT 8075, 22* (Dec. 2010), available at <http://www.ato.gov.au/content/downloads/BUS-31962nat8075122010.pdf>. If the transition to an accelerated schedule creates a significant burden, Congress can create an incentive to encourage the behavior in the transition years, such as providing a tax credit to recover the incremental costs of transition.

to file information returns electronically. In addition, third-party reporters that are required to file 250 or more of any particular information return must file electronically.<sup>13</sup> The due date for most of these forms is one month later than the date for paper filing.<sup>14</sup> However, this extended deadline undermines the goal of processing these forms before releasing refunds. In addition, given advances in technology, it is reasonable for Treasury to tighten the mandate by significantly reducing the 250-return threshold. Thus, by tightening the e-file mandate and eliminating the extended e-file deadline, the IRS could minimize processing delays.<sup>15</sup>

***Coordination of Processing W-2s with the Social Security Administration Would Allow the IRS to Begin Processing These Documents Earlier.***

The IRS could begin processing W-2 data earlier if it receives the information at the same time or shortly after the forms are filed with the SSA. Employers file Forms W-2 with the SSA — not the IRS — and the SSA screens the forms to identify name/SSN mismatches before sending data extracts to the IRS. The length of time between the SSA's receipt and transmission to the IRS should be assessed. If there is a significant lag, the IRS should evaluate options to reduce the delay, including processing improvements and whether the IRS could receive the data directly and perform the screens itself.<sup>16</sup>

***Real-Time Downloading of Data into the Database and Running the IRMF Screen with Other Pre-Refund Screens Could Protect Revenue by Preventing Incorrect Refunds.***

In order to match documents before releasing refunds, the IRS's Information Return Master File (IRMF) database should upload information return data soon after the information returns are received by the IRS. However, the current return processing pipeline does not permit the IRS to run refund claims against the database in a timely manner. Thus, in order to match documents before releasing refunds, the IRS must modify the pipeline so it can run an IRMF screen simultaneously with its other pre-refund screens.<sup>17</sup>

<sup>13</sup> Treas. Reg. § 301.6011-2. The requirement applies to Forms 1042-S, 1098, 1098-E, 1098-T, 1099 series, 5498, 8027 and W-2G. There is a hardship waiver to this requirement. In fiscal year 2010, the IRS received approximately 2.69 billion information returns, of which 2.36 billion were filed electronically. 2010 Internal Revenue Service Data Book 37, Table 14 (Mar. 2011).

<sup>14</sup> IRS Publication 1220, *Specifications for Filing Forms 1097-BTC, 1098, 1099, 3921, 3922, 5498, 8935, and W-2G Electronically*; Rev. Proc 2010-26, 2010-30 I.R.B. 91 (July 26, 2010).

<sup>15</sup> In its final report, the National Commission on Restructuring the Internal Revenue Service recommended that the threshold for electronic submission of information returns be lowered to 100. Report of the National Commission on Restructuring the Internal Revenue Service, *A Vision for a New IRS*, Appendix G (June 25, 1997). Information returns filed on paper with the IRS are required to be scannable and are transcribed manually when the taxpayer does not meet this requirement. IRS General Instructions for Certain Information Returns (2011) (Forms 1097, 1098, 1099, 3921, 3922, 5498, and W-2G), Section G. Paper Document Reporting; IRS, *Seven-Day Response to Most Serious Problem: Accelerated Third Party Info Reporting* (Nov. 17, 2011).

<sup>16</sup> Because both the IRS and SSA need the W-2 data, consideration should be given to sending the information to a joint processing center. Both the IRS and SSA would have immediate access to the data at the center. Alternatively, a portal could be created to give the IRS direct access to the SSA database.

<sup>17</sup> The National Taxpayer Advocate has concerns with respect to how the IRS will notify taxpayers that there is a question about IRMF data on their returns and what legal authority the IRS has to adjust the return. See Most Serious Problem: *The IRS's Wage and Withholding Verification Process May Encroach on Taxpayer Rights and Delay Refund Processing*, *supra*; Introduction to Revenue Protection Issues: *As the IRS Relies More Heavily on Automation to Strengthen Enforcement, There Is an Increased Risk that It Will Assume Taxpayers Are Cheating, Confuse Taxpayers About Their Rights, and Sidestep Longstanding Taxpayer Protections*, *supra*. Nevertheless, the IRS should proceed with modifying its pipeline while we work through these concerns.

*Encourage Taxpayers to Wait for Third-Party Data Before Filing Returns.*

While the IRS has a significant revenue protection interest in performing document matching before releasing refunds, taxpayers who are entitled to refunds should not be forced to wait for an extended time. Low income taxpayers in particular may have difficulty, at least initially, adjusting to any changes in their accustomed timeframe for receiving refunds.<sup>18</sup> Once the IRS manages to expedite third-party data processing, it should conduct a marketing campaign to entice taxpayers to wait for the data to be available before preparing and filing returns. The campaign should list the many benefits of accessing third-party data before filing returns, such as confidence in the completeness of the return.<sup>19</sup>

With the virtual elimination of the refund anticipation loan market, most taxpayers will have to wait to receive their refunds.<sup>20</sup> Taxpayers might be even more willing to wait if the IRS offers them the ability to download their third-party data directly into their return preparation software or even provide a pre-populated return option to either (1) accept as prepared or (2) modify with additional information.<sup>21</sup> Taxpayers and their authorized preparers already have electronic access to some of this data directly from the third-party reporters. However, the IRS could create a “one-stop shopping” platform for the taxpayer to receive all data from one government-provided location. With direct electronic access to a complete set of downloadable third-party data, compliance would increase through the elimination of keystroke mistakes and inadvertent omissions.

The wait might be even more acceptable to taxpayers once the IRS has fully migrated all applications to the new CADE 2 database and can process returns quicker. Once taxpayers are accustomed to this approach, third-party filers have sufficiently transitioned, and the IRS systems have fully incorporated the benefits of CADE 2, the IRS can evaluate moving the start of the filing season later to coincide with the completion of the IRMF database.<sup>22</sup>

<sup>18</sup> 28.8 percent of tax year 2009 returns filed in processing year 2010 were filed by Feb. 28, 2010. Of those early filed returns, 98.5 percent were due a refund, with the average refund amounting to approximately \$3,273. In addition, 38.9 percent of the early filers claimed EITC. Individual MasterFile and Individual Returns Transaction File tax year 2009 processing year 2010 from the Compliance Data Warehouse (Oct. 2011).

<sup>19</sup> In § 2001 of RRA 98, Congress authorized the IRS “to promote the benefits of and encourage the use of electronic tax administration programs, as they become available, through the use of mass communications and other means...[and] implement procedures to provide for the payment of appropriate incentives for electronically filed returns.” Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), § 2001(c), Pub L. 105-206, 112 Stat. 723 (July 22, 1998). Our proposal is an extension of this program.

<sup>20</sup> A refund anticipation loan is a short-term loan secured by a taxpayer’s anticipated tax refund. See IRS, IRS Removes Debt Indicator for 2011 Tax Filing Season, IR-2010-89 (Aug. 5, 2010); Sandra Block, IRS Rule to End Release of Debt Info Threatens Refund-Anticipation Loans, USA Today (Aug. 6, 2010);

<sup>21</sup> The National Commission on Restructuring the Internal Revenue Service envisioned the realignment of due dates for tax return and third-party reporting. Report of the National Commission on Restructuring the Internal Revenue Service, *A Vision for a New IRS* 39 (June 25, 1007) (“Realigning the due dates for tax and information returns could rationalize the entire filing process, provide a more realistic timetable for submission and incentives for electronic filing, level the workload of the IRS and tax practitioners, and establish the foundation for return-free filing for many individual taxpayers.”).

<sup>22</sup> For a comprehensive discussion of the experience in various countries in developing and implementing pre-populated tax return programs, see *Studies in Budget & Tax Policy: Prefilled Personal Income Tax Returns: A Comparative Analysis of Australia, Belgium, California, Québec, and Spain* (Frasier Institute June 2011). Chapter 1 of such study (authored by Chris Evans and Binh Tran-Nam) discusses the obstacles faced by Australia in receiving third-party data at a point in the filing season that is well after the time such users would normally file. The discussion also addresses the benefits to taxpayers and tax administrators. Countries with pre-populated returns often start the filing season several months after the end of the tax year. See OECD, Forum on Tax Administration Taxpayer Services Subgroup, *Using Third-Party Information Reports to Assist Taxpayers Meet their Return Filing Obligations – Country Experiences with the Use of Pre-Populated Personal Tax Returns* (Mar. 2006).

IRS Commissioner Douglas Shulman also described a tax system with improved use of third-party data when he recently stated:

I also see technology as one of the keys for unlocking a potential new tax structure that could fundamentally change the way taxpayers and tax practitioners prepare and file individual returns. It would deal in real time and avoid audits that may take place three years after a return is filed.

In this long-term vision, the IRS could get all information from third parties before individual taxpayers filed their returns. Taxpayers or their return preparers could then access that information, via the Web, to prepare their tax returns.

Taxpayers or their return preparers could then add any self-reported and supplemental information to the returns, and file it with the IRS. The IRS could embed this third-party information into its pre-screening filters, and could ask the taxpayer to fix the return before accepting it if it contains data that does not match the taxpayer's records. This is a real game-changer as it could help ensure more accurate returns and far less of the troublesome back-end auditing.<sup>23</sup>

#### **Despite Challenges, Pre-populated Returns Will Improve Taxpayer Compliance.**

The pre-populated return is not a novel idea. In fact, § 2004 of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98) mandated that the Department of Treasury develop procedures to implement a return-free tax system for appropriate individuals by 2007.<sup>24</sup> The provision further called for the Secretary to report periodically on the additional resources the IRS would need to implement the system, the changes to the Internal Revenue Code that would enhance such a system, the procedures developed for the implementation of a return-free tax system for appropriate individuals, and the number and classes of taxpayers permitted to use those procedures.<sup>25</sup>

In a 2003 report mandated by RRA 98, the Department of Treasury analyzed the various types of return-free systems around the world and identified challenges faced by other countries as well as findings from its own independent research. In general, countries ei-

<sup>23</sup> IRS, IR-2011-55, *Prepared Remarks of IRS Commissioner Doug Shulman to the Leaders & Legends Series, Johns Hopkins Carey Business School, Baltimore* (May 18, 2011).

<sup>24</sup> Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), § 2004 (a), Pub L. 105-206, 112 Stat. 726 (July 22, 1998) ("The Secretary of the Treasury or the Secretary's delegate shall develop procedures for the implementation of a return-free tax system under which appropriate individuals would be permitted to comply with the Internal Revenue Code of 1986 without making the return required under section 6012 of such Code for taxable years beginning after 2007.")

<sup>25</sup> Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), § 2004 (b), Pub L. 105-206, 112 Stat. 726 (July 22, 1998).

ther had an exact withholding system or a tax agency reconciliation system.<sup>26</sup> The Treasury report included the following findings from its review:

- The simpler the tax system, the easier it is to operate a return-free system.
- In a 2000 IRS telephone survey of taxpayers' attitudes toward a return-free system, approximately 72 percent of the respondents expressed concerns regarding increased government control over individuals' lives.<sup>27</sup>
- At the time of the report, many countries with return-free systems had exact withholding systems, which shift the burden to payers of income. In addition, it is difficult to apply progressive tax rates in an exact withholding system when income is derived from many sources. Thus, the burden on the payers and tax administration would decrease if the requirement applied only to taxpayers in the lowest tax bracket;
- With a tax agency reconciliation system, third-party reporters would be required to accelerate reporting and the IRS and SSA would have to speed up the processing and editing of these returns to avoid significant delays in refunds.<sup>28</sup>

The National Taxpayer Advocate believes these challenges are not insurmountable. First, technology has advanced in the years since these concerns were raised. We agree that a simpler tax system is ideal and would make administration of a return-free system less burdensome. However, the U.S. can make the system voluntary so that taxpayers with less complicated returns can use the system to prepare their complete returns. Those with more complicated returns can make adjustments to the pre-populated return. Finally, the IRS can address the government intrusion concern in a marketing campaign that conveys that the IRS would be making accessible to taxpayers information it already has, and the result of that access is to reduce the taxpayers' burden.

While there are many ways to implement a pre-populated return, one possibility would be to use the existing Free File Fillable Forms program, which is accessible on the IRS website. The proposed program would download the taxpayers' third-party data, populate the tax return, and perform basic calculations. Because not everything that must be reported on a return is subject to third-party reporting, taxpayers would still need to fill in information such as family status and composition, and other items of income, deductions, and credits.

<sup>26</sup> Treasury differentiated between two types of return-free systems: (1) an exact withholding system whereby the tax agency attempts to ensure that the exact amount of tax liability is withheld so that taxpayers are not required to file returns at the end of the year, and (2) a tax agency reconciliation system, whereby taxpayers can elect to have the tax agency prepare their returns. The tax agency reconciliation system has four steps: (1) electing taxpayers provide basic information to the tax authority; (2) the tax authority then calculates tax liabilities, given the information returns it receives; (3) the taxpayer then has a chance to review (and contest) these calculations; and (4) refunds or tax payments are made.

<sup>27</sup> Dept. of Treasury, *Report to the Congress on Return-Free Tax Systems: Tax Simplification Is a Prerequisite* 26 (Dec. 23, 2003), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/noreturn.pdf> 28 (last visited Nov. 1, 2011).

<sup>28</sup> *Id.*

In addition, the IRS can evaluate the feasibility of delaying the filing deadline for pre-populated returns to encourage more taxpayers to participate in the program.<sup>29</sup>

The IRS can learn from the experiences of other jurisdictions in providing taxpayers with timely electronic access to third-party reporting. The National Taxpayer Advocate has met with tax administrators from numerous countries and has discussed a variety of approaches, including setting earlier deadlines for information reporting and starting the filing season later in the year. Several of these countries, such as Sweden and Australia, also generate pre-populated returns to simplify return preparation for its taxpayers. In the United States, California administers the ReadyReturn program.<sup>30</sup>

## CONCLUSION

The IRS does not fully utilize its third-party reporting system to maximize the potential benefits to taxpayers as well as tax administration. If the IRS received, processed, and made third-party data accessible to taxpayers before return filing deadlines, both taxpayers and the IRS would benefit through higher compliance rates and fewer downstream consequences.

To reduce taxpayer burden and meet the needs of taxpayers as well as tax administration, the National Taxpayer Advocate preliminarily recommends that the IRS take the following actions:

1. Conduct a study on 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.
2. Evaluate ways to build the IRS Information Return Master File database in real time as information returns come in.
3. Provide taxpayers with the ability to download third-party data directly from the IRS into their return preparation software and evaluate the feasibility of developing a pre-populated return option for taxpayers.

<sup>29</sup> See Joseph Bankman, *Using Technology to Simplify Individual Tax Filing*, *National Tax Journal* (Dec. 2008); OECD, Forum on Tax Administration Taxpayer Services Subgroup, *Information Note, Third-party Reporting Arrangements and Pre-Filled Tax Returns: The Danish and Swedish Approaches* (Jan. 22, 2008); OECD, Forum on Tax Administration Taxpayer Services Subgroup, *Using Third-Party Information Reports to Assist Taxpayers Meet their Return Filing Obligations – Country Experiences with the Use of Pre-Populated Personal Tax Returns* (Mar. 2006); Joseph Cordes and Arlene Holen, Technology Policy Institute, *Should the Government Prepare Individual Income Tax Returns?* (Sept. 2010). All Party Parliamentary Taxation Group, *Pre-Populated Returns: Briefing Paper* (Sept. 2009)."

<sup>30</sup> See *Studies in Budget & Tax Policy: Prefilled Personal Income Tax Returns: A Comparative Analysis of Australia, Belgium, California, Québec, and Spain* (Fraser Institute June 2011); State of California Franchise Tax Board, *ReadyReturn: Frequently Asked Questions*, available at [http://www.ftb.ca.gov/readyReturn/faq\\_about.shtml](http://www.ftb.ca.gov/readyReturn/faq_about.shtml) (last visited on Aug. 25, 2011); OECD, Forum on Tax Administration Taxpayer Services Subgroup, *Using Third-Party Information Reports to Assist Taxpayers Meet their Return Filing Obligations – Country Experiences with the Use of Pre-Populated Personal Tax Returns* (Mar. 2006); OECD, Forum on Tax Administration Taxpayer Services Subgroup, *Survey Report: Survey of Trends and Developments in the Use of Electronic Services for Taxpayer Service Delivery* (Mar. 2010).

## IRS COMMENTS

The IRS recognizes the benefits that can be achieved for taxpayers and the tax system by receiving third-party information on an accelerated basis. The IRS has been working on the early development of a “real time” tax system. This vision was described by the IRS Commissioner in a speech to the National Press Club in April 2011.<sup>31</sup>

In that speech, the Commissioner described a vision where the IRS would move away from the traditional “look back” model of compliance, and instead perform substantially more “real time,” or upfront matching of tax returns when they are first filed with the IRS. The goal of this initiative is to improve the tax filing process by reducing burden for taxpayers and improving overall compliance upfront.

Under the envisioned “real-time” tax system, the IRS would get information returns, such as Forms W-2 and 1099, from third parties before individual taxpayers filed their returns. The IRS could then check submitted information during processing and provide taxpayers an opportunity to fix inconsistent data before the return is accepted.

This is a long-term vision that will take some time to fully realize. The IRS is soliciting feedback and input from outside stakeholders on the proposal. We are in the process of holding a series of public meetings to gather insight on implementing this fundamental long-term change. We look forward to working with the National Taxpayer Advocate as we take steps to realize this vision.

## Taxpayer Advocate Service Comments

We commend the IRS for recognizing the need for accelerated third-party reporting. In fact, the IRS demonstrated its commitment to this important issue on December 8, 2011 when it kicked off a series of public meetings for the Real Time Tax System Initiative. During the initial meeting, there was universal agreement among the panelists that the IRS needs to move away from a “look back” model of compliance and toward upfront matching. However, the panelists also raised several questions about how the IRS would accomplish this, including the following:

1. ***Would the IRS reject returns that include mismatched data?*** The National Taxpayer Advocate shares the concerns of many of the panelists on this issue. Before implementing any program that would reject mismatched returns, the IRS should duly consider the resulting significant burden on both taxpayers and the IRS, and the potentially serious consequences for the taxpayers. For example, such a rejection would cause a significant number of taxpayers or their preparers to call the IRS

<sup>31</sup> IRS, *Prepared Remarks of Commissioner Doug Shulman at the National Press Club* (Apr. 6, 2011), available at [www.irs.gov/newsroom/article/0,,id=238204,00.html](http://www.irs.gov/newsroom/article/0,,id=238204,00.html).

toll-free line. It could also cause more taxpayers to file by paper if they cannot resolve inaccuracies before April 15. While it is ideal to inform taxpayers about mismatches as early as possible, the IRS does not necessarily need to reject a return to accomplish this goal. The IRS should consider which method creates the least burden.<sup>32</sup>

2. **Who would have access to the real-time tax data?** Taxpayers should have access to third-party data before they file their returns. This access, which would prevent mismatches from happening at all, would become even more imperative should the IRS decide to reject returns with mismatches. Ideally, the IRS would build a system that enables taxpayers to download the data directly to their return preparation software as well as making pre-populated returns available.<sup>33</sup>
3. **Expansion of Math Error Authority.** The National Taxpayer Advocate cautions against the expansion of math error authority under IRC § 6213(g) to cover mismatched third-party data.<sup>34</sup> Such expansion would significantly harm taxpayers, especially low income taxpayers who may not understand the notices or realize the need to respond in a timely manner. Accordingly, these taxpayers may lose their right to contest the adjustment in Tax Court.<sup>35</sup>

As the IRS develops the real-time tax system, the National Taxpayer Advocate has serious concerns about the protection of fundamental taxpayer rights. We urge the IRS to develop procedures for accelerated information reporting to afford taxpayers with the same standard taxpayer rights that accrue during a traditional examination.<sup>36</sup> In the past, the IRS has not considered automated adjustments resulting from third-party data mismatches to be “examinations.”<sup>37</sup> Thus, 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

<sup>32</sup> See, e.g., American Institute of Certified Public Accountants Statement Presented to the Internal Revenue Service on Real Time Tax System 3 (Dec. 8, 2011); Comments of Bonnie Speedy, Vice President and National Director, AARP Foundation Tax-Aide, IRS Public Meeting – Real Time Tax System (Dec. 8, 2011).

<sup>33</sup> See also Comments of T. Keith Fogg, Director, Villanova Law School Federal Tax Clinic, IRS Real Time Tax System Initiative 3-4 (Dec. 8, 2011).

<sup>34</sup> IRC § 6213(b) or (g) gives the IRS the authority to make an assessment without filing a statutory notice of deficiency (SNOD). Once the IRS notifies taxpayers of math errors, they have 60 days to request abatement of the additional tax. If the taxpayer makes a timely request, the IRS will abate the assessment and follow formal deficiency procedures to reassess the tax (i.e., send the taxpayer a SNOD). However, if the taxpayer fails to request abatement timely, the IRS may collect the additional tax. At this point, the assessment cannot be appealed in the U.S. Tax Court. See Most Serious Problem: *Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights*, *supra*; Legislative Recommendation: *Mandate That the IRS, in Conjunction with the National Taxpayer Advocate, Review any Proposed Expanded Math Error Authority to Protect Taxpayer Rights*, *infra*.

<sup>35</sup> See, e.g., Comments of T. Keith Fogg, Director, Villanova Law School Federal Tax Clinic, IRS Real Time Tax System Initiative 4-5 (Dec. 8, 2011);

<sup>36</sup> Introduction to Revenue Protection Issues: *As the IRS Relies More Heavily on Automation to Strengthen Enforcement, There Is an Increased Risk that It Will Assume Taxpayers Are Cheating, Confuse Taxpayers About Their Rights, and Sidestep Longstanding Taxpayer Protections*, *supra*.

<sup>37</sup> See, e.g., Rev. Proc. 2005-32, § 4.03 2005-1 C.B. 1206.

unnecessary examinations, adequate notice by the IRS, and an opportunity to contest the proposed adjustment administratively and in Tax Court.<sup>38</sup>

In addition, the inaccuracy of third-party data is a significant issue with direct impact on both taxpayers and the IRS. If the IRS identifies a mismatch, and does not receive a taxpayer response to an automatically-generated letter, the IRS assumes the third-party data is correct and the information reported on the tax return is incorrect, without conducting any further investigation. However, the high abatement rate on AUR assessments indicates that third-party data may not be reliable and illustrates the need for the IRS to improve procedures to verify return information<sup>39</sup>

Finally, the reliability of third-party data has a direct impact on the IRS if the taxpayer challenges in court an adjustment based solely on third-party data, about which the taxpayer has responded to the IRS. In such a case, the burden of production shifts to the Commissioner, who must produce “reasonable and probative information concerning such deficiency in addition to such information return.”<sup>40</sup>

During the December 8, 2011 public meeting, Commissioner Shulman stated that the IRS would not address pre-filled returns as a part of this initiative. We understand the need to focus on the real-time issues before building on the system to develop pre-populated or pre-filled returns. However, we urge the IRS, as it builds the real-time infrastructure, to consider how any future pre-populated return program would interact with the system. The National Taxpayer Advocate continues to believe that the provision of a pre-populated return would significantly reduce burden on taxpayers and increase compliance.

<sup>38</sup> See generally IRS Pub 1, *Your Rights as a Taxpayer* (2005); IRS, Pub. 556, *Examination of Returns, Appeal Rights and Claims for Refund* (2008); IRS Pub. 3498-A, *The Examination Process* (2004); Introduction to Revenue Protection Issues: *As the IRS Steps up Enforcement Using Automation, There Is an Increased Risk that It Will Assume Taxpayers Are Cheating, Confuse Taxpayers About Their Rights, and Sidestep Longstanding Taxpayer Protections*, *supra*.

<sup>39</sup> The IRS granted 83.3 percent of all AUR abatement requests in FY 2011. IRS, Enforcement Revenue Information System Summary Database (Dec. 2011). Further, according to TIGTA, more than two billion information returns were submitted to the IRS in TY 2007, of which 31.7 million (1.5 percent) had invalid payee data. TIGTA, Ref. No. 2011-30-019, *Targeted Compliance Efforts May Reduce the Number of Inaccurate Returns Submitted by Government Entities* 3-4 (Feb. 15, 2011).

<sup>40</sup> IRC § 6201(d). Congress enacted IRC § 6201(d) following the decision in *Portillo v. Commissioner*. *Portillo v. Comm’r*, 932 F.2d 1128 (5th Cir. 1991). Section 6201(d) places the burden of production in litigation on the Commissioner where the taxpayer raises a reasonable dispute concerning certain information returns supplied by third parties. In *Portillo*, the court found the IRS’s determination that the taxpayer had received unreported income was arbitrary and erroneous, because a Form 1099 sent to the IRS by another taxpayer was the sole basis for the determination. The court concluded that the IRS had a duty to investigate the accuracy of the Form 1099 and determine if it could be verified by other information, such as the books or records of the taxpayer who submitted the Form 1099. The court held the IRS did issue a valid deficiency notice but determined that notice to be arbitrary and erroneous, because the IRS failed to substantiate the charge that the taxpayer had unreported income.

## Recommendations

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

1. Conduct a study of 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.
2. Evaluate ways to build the IRS Information Return Master File database in real time as information returns are submitted to the IRS.
3. Provide taxpayers with the ability to download third-party data directly from the IRS into their return preparation software.
4. Evaluate the feasibility of developing a pre-populated return option for taxpayers.
5. Study the accuracy of third-party reporting data, analyzing its reliability by type of third-party reports (such as interest, dividend, broker transactions, cancellation of debt, merchant card and third party network payments, nonemployee compensation, certain government payments, etc).
6. Develop procedures for accelerated third-party reporting that do not include math error authority for adjustments based solely on third-party reporting mismatches.
7. Develop procedures for accelerated third-party reporting that provide taxpayers with the standard taxpayer rights that accrue during an examination, including a prohibition on repetitive and unnecessary examinations, adequate notice, and an opportunity to contest the proposed adjustment administratively and in Tax Court.
8. Develop procedures pursuant to IRC § 6201(d) that provide the protections afforded to taxpayers who have responded to the IRS and challenge an adjustment based solely on information return data in court.
9. Work with the National Taxpayer Advocate to design any associated taxpayer notices in a clear and straightforward manner so the taxpayer can easily understand his or her rights in the process, the changes made by the IRS, and the steps to take if the taxpayer disagrees with the adjustment.

## MSP #14

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

### RESPONSIBLE OFFICIALS

Richard E. Byrd Jr., Commissioner, Wage and Investment Division  
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### DEFINITION OF PROBLEM

The Earned Income Tax Credit (EITC), a refundable credit available to working low income taxpayers, lifted approximately six million individuals, including approximately three million children, out of poverty in 2009.<sup>1</sup> At the same time, this essential program is now classified as the fourth largest source of “improper payments” by the government in fiscal year (FY) 2010.<sup>2</sup> This classification is based on a compliance estimate derived from old 2006 data and is most likely overstated.<sup>3</sup> Moreover, the IRS has not released studies for subsequent years to the Taxpayer Advocate Service (TAS) or the public, which means that although the estimates of improper payments are published, the underlying data and assumptions are not.

Overstated or not, however, there is room for improvement in the administration of EITC, which now accounts for approximately 37 percent of *all* individual taxpayer audits, even though other components of the tax gap have greater noncompliance.<sup>4</sup> While the IRS is collaborating with TAS on pilot programs to improve EITC service and foster compliance, there is more to be done. The IRS should not only refine the compliance measurement itself, but should explore proposals to improve EITC compliance while reducing taxpayer burden and protecting taxpayer rights.

Efforts to reduce improper payments should not curtail EITC’s successes. In particular:

- 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.

<sup>1</sup> The most recent year for which data are available is 2009. IRS Individual Returns Transaction File (IRTF) tax year 2009 data from the Compliance Data Warehouse (CDW) (Oct. 2011); accord John Wancheck and Robert Greenstein, Center on Budget and Policy Priorities, *Earned Income Tax Credit Overpayment and Error Issues* 1 (Apr. 19, 2011).

<sup>2</sup> Government Accountability Office (GAO), GAO-11-575T, *Improper Payments: Recent Efforts to Address Improper Payments and Remaining Challenges*, Table 1 at 4 (Apr. 15, 2011).

<sup>3</sup> The compliance estimate referenced in the GAO report is the IRS FY 2010 estimate based on tax year (TY) 2006 data. Also note the more recent IRS 2011 estimate incorporating TY 2007 data in the IRS response to this Most Serious Problem, *infra*.

<sup>4</sup> IRS Pub. 55B, *Data Book* (2010), Table 9a. On the tax gap, business income of \$109 billion went unreported by individuals in TY 2001. IRS, *Reducing the Federal Tax Gap – A Report on Improving Voluntary Compliance*, Fig. 1 at 10 (Aug. 2, 2007). For FY 2009, \$11 to \$13 billion of EITC payments were considered improper. Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2011-40-023, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Payments Each Year* 1 (Feb. 7, 2011).

- EITC administration and compliance measures should take into account the taxpayer's learning curve. The population of taxpayers eligible for the credit changes by an estimated one-third annually, which means that one in three EITC taxpayers each year is in a learning mode.<sup>5</sup>
- The intricacies of the EITC law (set forth in IRS Publication 596, *Earned Income Credit*, designed to present "Earned Income Credit in a Nutshell" (yet now running 63 pages) should be applied to each taxpayer's facts — not to data that may afford administrative shortcuts while abridging individual rights.

## ANALYSIS OF PROBLEM

### Background

The IRS is responsible for administering the EITC, a refundable tax credit available to certain low income working taxpayers and their families.<sup>6</sup> The EITC was enacted in 1975 to provide an incentive to work and offset the burden of Social Security taxes for low income working families.<sup>7</sup> Because the credit is refundable, if the EITC exceeds the taxes owed, the IRS refunds the overpayment to the taxpayer. The credit can be substantial for a working family. For tax year (TY) 2011, the maximum EITC for a married couple with three (or more) qualifying children is more than \$5,700.<sup>8</sup> Among taxpayers who received both EITC benefits and tax refunds for TY 2009, the refund amounted to approximately 24 percent of adjusted gross income.<sup>9</sup>

The EITC has become an important anti-poverty program with high participation rates at comparatively low costs. EITC lifted 6.6 million individuals, about half of whom were children, out of poverty in 2009 (the most recent year for which data are available).<sup>10</sup> Because EITC funds can be a vital component of a family's basic living expenses, the credit presents a special case in which tax administration should encourage participation as well as compliance. At the same time, the EITC has a high rate of overpayments. As a result, it was classified as the fourth largest source of "improper payments" by the government in FY 2010.<sup>11</sup>

<sup>5</sup> TIGTA, Ref. No. 2009-40-024, *The Earned Income Tax Credit Program Has Made Advances; However, Alternatives to Traditional Compliance Methods Are Needed to Stop Billions of Dollars in Erroneous Payments 2* (Dec. 31, 2008).

<sup>6</sup> Internal Revenue Code (IRC) § 32.

<sup>7</sup> Pub. L. No. 94-12, 89 Stat. 26 (1975); S. Rep. 94-36, 94th Cong. 1st Sess. (1975) 33 ("your committee agrees with the House that it is appropriate to use the income tax system to offset the impact of the social security taxes on low income persons in 1975 by adopting a refundable income tax credit against earned income").

<sup>8</sup> Rev. Proc. 2011-12, 2011-2 I.R.B. 1.

<sup>9</sup> The average AGI was \$17,292; average refund, \$4,108. IRS IRTF for TY 2009 from the CDW (Oct. 2011).

<sup>10</sup> John Wancheck and Robert Greenstein, Center on Budget and Policy Priorities, *Earned Income Tax Credit Overpayment and Error Issues 1* (Apr. 19, 2011).

<sup>11</sup> GAO, GAO-11-575T, *Improper Payments: Recent Efforts to Address Improper Payments and Remaining Challenges*, Table 1 at 4 (Apr. 15, 2011).

The Improper Payments Information Act of 2002 requires the IRS to estimate the amount of such payments and report to Congress on steps to reduce them.<sup>12</sup> For TY 2009, the IRS reported that 24 million taxpayers received \$55 billion in EITC and that for FY 2009, 23 to 28 percent, or \$11 to \$13 billion,<sup>13</sup> was improper.<sup>14</sup> The IRS also disclosed that this figure is based on an historical sample of tax returns rather than current filings, analyzed, projected, and adjusted to estimate the rates of mistakes and noncompliance.<sup>15</sup>

### The IRS may be relying on a misleading estimate of EITC noncompliance.

Research studies report that the IRS's estimate of improper payments may be flawed and is most likely significantly overstated.<sup>16</sup> Specifically, estimates of improper EITC payments have an uncertain statistical basis to the extent that they are based on audit results. A majority (60 percent) of EITC audits are conducted by correspondence (pre-refund) before the credit is paid.<sup>17</sup> In these audits, almost 70 percent of the taxpayers do not respond to the audit inquiry letters from the IRS,<sup>18</sup> which then denies the EITC.<sup>19</sup> A 2004 TAS Research study found that on reconsideration of audits, about 17 percent of taxpayers were unaware they had been under audit, and 43 percent of taxpayers "were entitled to virtually all of the EITC they claimed," that is "on average, 94 percent of the EITC amount claimed on the original return."<sup>20</sup>

The data suggest audit outcomes are frequently incorrect because the IRS erroneously denies a significant number of credits.<sup>21</sup> Further, the Treasury Inspector General for Tax Administration has expressed concern that the improper payment rate does not account for individuals who are eligible for the EITC and do not claim it.<sup>22</sup> Additionally, the

<sup>12</sup> Pub. L. No. 107-300, 116 Stat. 2350.

<sup>13</sup> TIGTA, Ref. No. 2011-40-023, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Payments Each Year 1* (Feb. 7, 2011).

<sup>14</sup> Pub. L. No. 107-300, § 2(d)(2)(A) (generally governing payments over \$10 million "derived from Federal funds") defines an "improper payment" as any payment that should not have been made or that was made in an incorrect amount. The Office of Management and Budget (OMB) has imposed a 2.5 percent floor on improper payments. See OMB Circ. A-123, Appdx. C, M-11-16, Pt. I at 5 (Apr. 14, 2011) (imposing threshold of 2.5 percent of program outlays).

<sup>15</sup> *Hearing Before the H. Ways and Means Comm. Subcomm. on Oversight on Refundable Tax Credits* 10, 112th Cong. (May 25, 2011) (statement of Steven T. Miller, Deputy Commissioner for Services and Enforcement, Internal Revenue Service).

<sup>16</sup> TIGTA, Ref. No. 2011-40-023, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Payments Each Year 13* (Feb. 7, 2011); see also *Hearing on Improper Payments in the Administration of Refundable Tax Credits Before the Subcomm. on Oversight Comm. on Ways and Means* 17, 112th Cong. (May 25, 2011) (statement of Nina E. Olson, National Taxpayer Advocate).

<sup>17</sup> TIGTA, Ref. No. 2011-40-023, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Payments Each Year 29* (Feb. 7, 2011) ("Of the approximate 500,000 audits conducted by the IRS annually, 60% are conducted before the EITC portion of the refund is released.").

<sup>18</sup> IRS Automated Information Management System (AIMS) FY 2010 (Oct. 2011) (ranging from 63 to 73 percent); see also National Taxpayer Advocate 2004 Annual Report to Congress vol. 2, 9 (*EITC Audit Reconsideration Study*) ("Communication challenges (taxpayers had not responded or responded late) were the trigger 38 percent of the time.").

<sup>19</sup> In FY 2010, the IRS fully or partially disallowed approximately 87 percent of taxpayer claims for EITC. IRS Automated Information Management System (AIMS) FY 2010 (Oct. 2011).

<sup>20</sup> See National Taxpayer Advocate 2004 Annual Report to Congress vol. 2, i, 21, 29 (*EITC Audit Reconsideration Study*).

<sup>21</sup> National Taxpayer Advocate FY 2004 Objectives Report to Congress 21.

<sup>22</sup> TIGTA, Ref. No. 2011-40-023, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Payments Each Year 13* (Feb. 7, 2011).

computation does not include instances where a wrongly claimed EITC would be allowable to another taxpayer. In this case, any loss to the Treasury is a net figure.<sup>23</sup>

It is difficult to suggest improvements to the methodology behind the computation of improper payments without additional information. A 2001 IRS estimate of improper EITC payments has still not been released for review, apparently because it is not comparable to a prior study (relating to 1999).<sup>24</sup> Similarly, the IRS has not released studies for subsequent years to TAS or the public, which means that although the estimates of improper payments are published, the underlying data and assumptions are not. It would be in the best interest of tax administration to share these data, invite rigorous professional and peer review, and reevaluate the estimates.

Designating EITC as the fourth largest improper payment may be misleading. Not only was the potentially flawed estimate the basis for a GAO report indicating that improper EITC payments jumped from approximately \$12 billion in FY 2009 to \$16.9 billion in FY 2010, but the GAO report did not explain increases in overall eligibility rates.<sup>25</sup> The number and amount of EITC claims have steadily increased each year, for reasons unrelated to noncompliance. Two factors may contribute to the recent reported increase in the dollar amount of EITC noncompliance. The American Recovery and Reinvestment Act of 2009 expanded the EITC to remedy a marriage penalty and allow a higher rate for taxpayers with three (or more) children.<sup>26</sup> At the same time, the economic recession may have increased the population of low income workers eligible for the EITC.

#### **Mere classification as an “improper payment” does not result in a solution.**

Even if the improper payment estimates are correct, the implications for tax administration are unclear. EITC, the single tax provision classified as an “improper payment,” accounts for only a small percentage of the tax gap.<sup>27</sup> By contrast, in a study of tax compliance, the IRS determined business income of \$109 billion went unreported by individuals, almost ten times the amount of EITC payments now considered improper.<sup>28</sup> By this measure, “improper payment” status should not necessarily make EITC a higher priority. Even if it does become a higher priority, alternative solutions range from preparer regulation and

<sup>23</sup> John Wancheck and Robert Greenstein, Center on Budget and Policy Priorities, *Earned Income Tax Credit Overpayment and Error Issues* 6 (Apr. 19, 2011).

<sup>24</sup> For the 1999 study, see IRS, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns* (Feb. 28, 2002).

<sup>25</sup> GAO, GAO-11-575T, *Improper Payments: Recent Efforts to Address Improper Payments and Remaining Challenges*, Table 1 at 4 (Apr. 15, 2011) (reflecting \$16.9 billion for FY 2010). For the \$12 billion figure, see TIGTA, Ref. No. 2011-40-023, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Payments Each Year 1* (Feb. 7, 2011) (reporting \$11 to \$13 billion of improper payments in FY 2009).

<sup>26</sup> Pub. L. No. 111-5, Div. B, § 1002, 123 Stat. 115, 312 (2009).

<sup>27</sup> According to the IRS’s 2001 tax gap estimates – the most recent available – taxpayers timely and voluntarily paid \$1.767 trillion and paid another \$55 billion late or as a result of IRS enforcement, leaving \$290 billion unpaid (the net tax gap). See IRS, *Reducing the Federal Tax Gap – A Report on Improving Voluntary Compliance*, Fig. 1 at 10 (Aug. 2, 2007).

<sup>28</sup> IRS, *Reducing the Federal Tax Gap – A Report on Improving Voluntary Compliance*, Fig. 1 at 10 (Aug. 2, 2007). For FY 2009, \$11 to \$13 billion of EITC payments were considered improper. TIGTA, Ref. No. 2011-40-023, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Payments Each Year 1* (Feb. 7, 2011). In turn, \$109 billion is almost ten times \$11 billion.

improved taxpayer service to more effective audits and elimination of Refund Anticipation Loans (RALs).

Reliably determining the EITC noncompliance rate is paramount because a number of upcoming initiatives should, if properly implemented, increase EITC compliance. In particular, the registration and testing of tax return preparers promises to take significant steps toward reducing EITC fraud and error because practitioners prepare 66 percent of all EITC returns (based on TY 2009 data).<sup>29</sup> The IRS cannot measure the impact of this initiative and others without a reliable starting point.

As previously mentioned, the Improper Payments Information Act of 2002 also requires the IRS to report on its steps to reduce improper payments. Executive Order 13520, on reducing improper payments, “targets error, waste, fraud, and abuse—not legitimate use of Government services.” Consequently, the executive order continues, “efforts to reduce improper payments under this order must protect access to Federal programs by their intended beneficiaries.”<sup>30</sup> This order highlights the expanded responsibility and dual mission of the IRS to not only collect taxes imposed by Congress but also administer social benefit programs such as the EITC.<sup>31</sup>

### **Correspondence audits are inapt as the primary tool used to address EITC noncompliance.**

The IRS relies primarily on an aggressive, audit-driven, compliance program to address improper EITC payments and verify the accuracy of EITC claims.<sup>32</sup> While acknowledging that this program cannot fully address EITC noncompliance,<sup>33</sup> the IRS has increased the number of EITC audits from 483,825 in FY 2009 to 585,202 in FY 2010, or approximately 34 to 37 percent, respectively, of *all* individual taxpayer audits.<sup>34</sup> Because the IRS has limited resources, any increase in EITC examinations can lead to a decrease in other audits designed to identify cash transactions and close the tax gap. EITC filers are already under disproportionate scrutiny, as they are almost twice as likely to be examined as other individual filers.<sup>35</sup>

<sup>29</sup> EITC Program Office response to TAS information request (May 18, 2011).

<sup>30</sup> 74 Fed. Reg. 62,201 (Nov. 25, 2009) § 1.

<sup>31</sup> For a discussion of the emerging dual mission of the IRS, refer to National Taxpayer Advocate 2010 Annual Report to Congress 15-27 (Most Serious Problem: *The IRS Mission Statement Does Not Reflect the Agency's Increasing Responsibilities for Administering Social Benefits Programs*).

<sup>32</sup> TIGTA, Ref. No. 2011-40-023, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Payments Each Year* (Feb. 7, 2011).

<sup>33</sup> *Id.*

<sup>34</sup> IRS Pub. 55B, *Data Book* (2010, 2009), Table 9 (FY 2010 had 585,202 EITC audits; FY 2009, 483,825).

<sup>35</sup> *Id.* at Table 9a, col. 3 at 22 (reporting 1.1 percent examination coverage of individual returns in total but up to 2.4 percent of EITC returns); EITC Program Office response to TAS information request (May 18, 2011).

The National Taxpayer Advocate has reported on the barriers, burdens, and complexity of EITC since 2001.<sup>36</sup> Statutorily, one barrier is the complicated eligibility criteria for the credit. IRS Publication 596, *Earned Income Credit*, designed to present “Earned Income Credit in a Nutshell,” is now 63 pages. Factually, relevant aspects of family situations can change from year to year, altering eligibility. It is estimated that the group of taxpayers eligible for the EITC changes by a third each year, which means at least a third of EITC taxpayers each year are learning about the credit.<sup>37</sup> Realistically, the EITC income requirement presents an opportunity to under-report or over-report, especially for self-employed taxpayers.

The IRS conducts almost all EITC audits by correspondence, with limited personal interaction.<sup>38</sup> This approach is particularly inappropriate for low income workers who face literacy challenges and are often transient.<sup>39</sup> Because the process does not meet taxpayer needs and characteristics, the EITC that the IRS denies may reflect the taxpayer’s inability to navigate the audit process rather than an improper payment.<sup>40</sup> Moreover, correspondence is not a reliable means of communication when, for example, a TIGTA audit estimated that during FY 2009 approximately 19.3 million pieces of mail, or almost ten percent of all correspondence for the year, were returned to the IRS.<sup>41</sup>

Commissioner Shulman recently said the goal for administering any social benefit program is to balance high participation with low noncompliance. He stressed, “There’s not a magic wand you can wave around the EITC.”<sup>42</sup> Nonetheless, the IRS can improve EITC compliance through preparer oversight, proper use of third-party data, and improved service to taxpayers under audit.

<sup>36</sup> National Taxpayer Advocate 2001 Annual Report to Congress 14, 20, 26, 36 (Most Serious Problems: *Determining EITC Eligibility; Documenting EITC; EITC Examinations; Recertification for EITC*); National Taxpayer Advocate 2002 Annual Report to Congress 47-87 (Most Serious Problems: *EITC Eligibility Determination Can Be Made Less Burdensome; Procedures for Examining EITC Claims Cause Hardship and Infringe on Appeal Rights; Lack of Response During EITC Exams; IRS Oversight of EITC Return Preparers Can Be Improved; The Length of EITC Audits Contributes to Taxpayer Concerns; EITC Recertification Compounds Taxpayer Burden*); National Taxpayer Advocate 2003 Annual Report to Congress 26, 87, 152, 163 (Most Serious Problems: *EITC Compliance Strategy; Combination Letter; EITC – Outreach & Education; EITC Nonfilers*); National Taxpayer Advocate 2005 Annual Report to Congress 94 (Most Serious Problem: *EITC Exam Issues*); National Taxpayer Advocate 2007 Annual Report to Congress 222 (Most Serious Problem: *EITC Examinations and the Impact of Taxpayer Representation*), vol. 2, 94, 118 (Research Studies: *IRS EIC Audits – A Challenge to Taxpayers; Simulating EITC Filing Behaviors: Validating Agent Based Simulation for IRS Analyses: The 2004 Hartford Case Study*); *Hearing on Improper Payments in the Administration of Refundable Tax Credits Before the Subcomm. on Oversight Comm. on Ways and Means*, 112th Cong. (May 25, 2011) (statement of Nina E. Olson, National Taxpayer Advocate).

<sup>37</sup> TIGTA, Ref. No. 2009-40-024, *The Earned Income Tax Credit Program Has Made Advances; However, Alternatives to Traditional Compliance Methods Are Needed to Stop Billions of Dollars in Erroneous Payments* 29 (Dec. 31, 2008).

<sup>38</sup> Automated Correspondence Examination (ACE) is a multifunctional software application that fully automates the initiation, aging, and closing of certain EITC and non-EITC cases. Using the ACE, the Correspondence Exam function can process specified cases with minimal to no tax examiner involvement until a taxpayer reply is received. Because the ACE system will automatically process the case through creation, statutory notice of deficiency, and closing, it eliminates tax examiner involvement entirely on no-reply cases. IRM 4.19.20.1 (Jan. 1, 2011).

<sup>39</sup> See generally National Taxpayer Advocate 2009 Annual Report to Congress 110 (Most Serious Problem: *Beyond EITC: The Needs of Low Income Taxpayers Are Not Being Adequately Met*).

<sup>40</sup> See National Taxpayer Advocate 2008 Annual Report to Congress 227-42 (Most Serious Problem: *Suitability of the Examination Process*).

<sup>41</sup> TIGTA, Ref. No. 2010-40-055, *Current Practices Are Preventing a Reduction in the Volume of Undelivered Mail* 1 (May 14, 2010); see National Taxpayer Advocate 2010 Annual Report to Congress 221-34 (Most Serious Problem: *The IRS Has Not Studied or Addressed the Impact of the Large Volume of Undelivered Mail on Taxpayers*).

<sup>42</sup> Alison Bennett, *IRS Working to Ensure Credit Card Reporting Information Properly Analyzed, Shulman Says*, Daily Tax Report (June 23, 2011).

**The IRS must establish an EITC compliance benchmark for preparer oversight.**

Sixty-six percent of EITC returns are prepared by paid tax preparers (based on TY 2009).<sup>43</sup> One might assume these returns would be more accurate than those prepared by the taxpayers themselves, but this is not the case. A return selected for EITC audit is more likely to be that of a paid preparer than self-prepared.<sup>44</sup> This is why the IRS Tax Return Preparer Initiative (RPI) is expected to significantly reduce EITC error (and even fraud). This program requires preparer registration, testing, and continuing education, with a focus on EITC eligibility.<sup>45</sup> The RPI also places all return preparers under the ethical rules of Circular 230, which gives the IRS disciplinary tools to address preparer misconduct.<sup>46</sup>

To increase preparer EITC compliance, the IRS should not only test preparers on their understanding of EITC eligibility, but also verify that preparers have met expanded EITC due diligence requirements.<sup>47</sup> The IRS is implementing a new requirement for preparers to provide their Preparer Tax Identification Number (PTIN) and file a due diligence checklist with the return when the preparer has helped the taxpayer claim the credit.<sup>48</sup> The National Taxpayer Advocate encourages the IRS in implementing this requirement, revising the related regulations to require preparers to inquire about the taxpayer's eligibility for the EITC, and review and retain specific information.<sup>49</sup>

The IRS should also closely monitor excessive EITC claims submitted by paid preparers. In the Automated Underreporter (AUR) Study of Preparers with Excessive EITC Claims, researchers were able to stratify automated underreporter cases and identify preparers with what appear to be excessive EITC on their clients' returns and even on their own individual returns.<sup>50</sup> This type of analysis, combined with the use of PTINs, has the potential to curtail many improper or negligent and potentially fraudulent EITC preparer practices. This study is a good advertisement for the need for real-time information return data.<sup>51</sup> While excellent, analysis of data in 2009 means as a chronological matter that these preparers may have filed excessive EITC claims for two additional years before they were identified (*i.e.*, TYs 2009 and 2010).

<sup>43</sup> EITC Program Office, *EITC Summary of Vital Statistics* (May 2011).

<sup>44</sup> Of FY 2010 EITC returns selected for audit, 75 percent were prepared by a paid preparer. IRS AIMS FY 2010 and IRTF from the CDW (Sept. 2011).

<sup>45</sup> Previously, a similar proposal was in National Taxpayer Advocate 2002 Annual Report to Congress 216 (Legislative Recommendation: *Regulation of Federal Tax Return Preparers*).

<sup>46</sup> Treasury Decision 9527, FR Doc. 2011-13666 (filed May 31, 2011), 76 Fed. Reg. 32,286 (June 3, 2011).

<sup>47</sup> Due diligence requirements provide guidance to tax return preparers to ensure information used and factors analyzed to claim EITC are correct. See Form 8867, *Paid Preparer's Earned Income Credit Checklist*.

<sup>48</sup> See Treas. Reg. § 1.6695-2, Treas. Decision 9570, 76 Fed. Reg. 78816 (Dec. 20, 2011); Notice of Proposed Rule-making, 76 Fed. Reg. 62,689 (Oct. 11, 2011). Previously, a proposal for certification by preparers based on the greatest compliance concerns was in National Taxpayer Advocate 2003 Annual Report to Congress 270 (Legislative Recommendation: *Federal Tax Return Preparers: Oversight and Compliance*).

<sup>49</sup> For relevant prior proposals, see National Taxpayer Advocate 2003 Annual Report to Congress 270 (Legislative Recommendation: *Federal Tax Return Preparers: Oversight and Compliance*); National Taxpayer Advocate 2002 Annual Report to Congress 216 (Legislative Recommendation: *Regulation of Federal Tax Return Preparers*).

<sup>50</sup> IRS, *TY09 EITC Preparer Analysis Observations* (Mar. 17, 2011).

<sup>51</sup> See Most Serious Problem: *Reinstatement of a Modernized Telefile Would Reduce Taxpayer Burden and Benefit Tax Administration, infra*.

The IRS contends, and the National Taxpayer Advocate agrees, that regulation of return preparers will markedly reduce improper EITC claims.<sup>52</sup> TIGTA, however, has found the IRS has not reported on how it plans to measure the impact of return preparer oversight on EITC overpayments, and it remains unknown whether increased preparer oversight will significantly reduce the improper payment rate. This concern underscores the immediate need to determine a reliable rate of EITC noncompliance to be used as a benchmark for RPI program effectiveness.

**Third-party data should be used as an indicator, not an absolute.**

The IRS recognizes it cannot fully address EITC noncompliance by simply auditing returns and must pursue alternatives to traditional compliance efforts.<sup>53</sup> At the end of 2010, the Department of the Treasury announced a pilot program to assess the availability, quality, completeness, and overall usefulness of state-administered benefits data, as well as state benefit screening processes, to help validate EITC eligibility. The pilot would address whether state data could identify both ineligible individuals who receive improper EITC payments and eligible individuals who do not claim the credit.<sup>54</sup>

Meanwhile, TIGTA has reiterated a recommendation that the IRS consider Federal Case Registry (FCR) information combined with increased math error authority to deny EITC during upfront processing of returns.<sup>55</sup> *Applying data collected for other purposes to deny EITC is shortsighted and may abridge taxpayer rights.*<sup>56</sup> Mass-production compliance efforts overlook the fact that most EITC errors result from applying the complexity of the EITC rules to the complexity of families' lives. If it was easy to determine and apply EITC eligibility, malfeasance or fraud would be the only reason for an improper payment.

The National Taxpayer Advocate continues to object specifically to the use of FCR data for *summary* denial of EITC claims.<sup>57</sup> A taxpayer should have an opportunity and the un-abridged due process right to present his or her own facts. In 1976, Congress specified that math error assessment is appropriate when “not only is the error apparent from the face of

<sup>52</sup> National Taxpayer Advocate 2009 Annual Report to Congress 41-69 (Most Serious Problem: *The IRS Lacks a Servicewide Return Preparer Strategy*).

<sup>53</sup> TIGTA, Ref. No. 2011-40-023 *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Payments Each Year* 30 (Feb. 7, 2011).

<sup>54</sup> Partnership Fund for Program Integrity Innovation Pilot Concept: Assessing State Data (Nov. 23, 2010); see also Dept. of the Treasury, *Performance and Accountability Rept.* FY 2010 at 280 (Nov. 15, 2010).

<sup>55</sup> TIGTA, Ref. No. 2009-40-024, *The Earned Income Tax Credit Program Has Made Advances; However, Alternatives to Traditional Compliance Methods Are Needed to Stop Billions of Dollars in Erroneous Payments* 13-14 (Dec. 31, 2008) (recommending that the IRS consider “Federal Case Registry information to determine its accuracy and applicability for exercising existing math error authority to deny the EITC during upfront processing of the tax return”), referenced in TIGTA, Ref. No.2011-40-023, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Payments Each Year* 9 (Feb. 7, 2011). IRC § 6213(b)(1) gives the IRS the authority to adjust an account for a mathematical, clerical, or other specified error or omission in IRC § 6213(g)(2) by issuing a notice instead of following Statutory Notice of Deficiency procedures.

<sup>56</sup> See Most Serious Problem: *Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights*, *supra*; National Taxpayer Advocate 2003 Annual Report to Congress 113 (Most Serious Problem: *Math Error Authority*); National Taxpayer Advocate 2002 Annual Report to Congress 187, 193-97 (Legislative Recommendation: *Math Error Authority*).

<sup>57</sup> For a discussion of the National Taxpayer Advocate's concerns about using FCR information, see National Taxpayer Advocate 2002 Annual Report to Congress 187, 193-97 (Legislative Recommendation: *Math Error Authority*).

the return, but the correct amount is determinable with a high degree of probability from the information that appears on the return.”<sup>58</sup> It is difficult, if not impossible, to apply the “High Degree of Probability Standard” to the fluid living arrangements parents make on a sometimes daily basis over the residency of their children.<sup>59</sup>

### Improved service can increase EITC compliance.

Two components of EITC eligibility, relationship and residency,<sup>60</sup> are particularly difficult to substantiate,<sup>61</sup> especially when low income taxpayers find the IRS’s letters and information requests confusing. IRS letters are legalistic, not tailored to the taxpayer’s particular situation, and do not discuss alternate sources of documentation. Low income persons may live without written leases or may not have school records for their children because of their living situation or patterns of moving. Migratory living patterns, lack of education, lack of time (*e.g.*, holding multiple jobs), lack of transportation, and limited access to technology (Internet, faxes, etc.) add to the difficulty of finding and submitting documents. IRS time-frames can be so tight that even if a low income taxpayer gathers the documents, by the time he or she submits them the IRS has already issued a Statutory Notice of Deficiency. If the taxpayers have moved, the mail may never reach them in time for a timely response.

In 2008, the IRS convened a Taxpayer Correspondence Taskgroup (TACT) Examination Team with the task of increasing voluntary taxpayer compliance and enhancing customer service by improving the language, content, and processes of written communications about audits. The team, which included TAS representation, reviewed research compiled by TAS and identified the Initial Contact Letter as a high-volume letter that needed substantial improvement.<sup>62</sup> The team made suggestions and designed a prototype, which the IRS referred to an outside contractor for improvement, but has not finalized and put into use. While the IRS has made significant progress updating account notices, the IRS has not yet finalized the Initial Contact Letter or the other high-volume letters used in correspondence examination.

TAS is collaborating with the IRS on two pilot programs to improve EITC compliance by improving service. One pilot tests the use of affidavits to establish qualifying child

<sup>58</sup> H. Rep. 94-658 (1976), p. 292; S. Rep. 94-938 (1976), p. 378.

<sup>59</sup> See Most Serious Problem: *Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights*, *supra*; see also Legislative Recommendation: *Mandate that the IRS, in Conjunction with the National Taxpayer Advocate, Review Any Proposed Expanded Math Error Authority to Protect Taxpayer Rights*, *infra*.

<sup>60</sup> Under the relationship requirement, a taxpayer generally may claim EITC with respect to a child who is his or her son, daughter, stepchild, foster child, or a descendant of any of them (*e.g.*, a grandchild), or a child who is a sibling, stepsibling, or half-sibling of the taxpayer, or a descendant of any of them. IRC § 152(c)(2). Under the residence requirement, a taxpayer generally may claim EITC only with respect to a child who lives with the taxpayer for more than half the calendar year. IRC § 152(c)(1)(B).

<sup>61</sup> See Leslie Book, *EITC Noncompliance: What We Don't Know Can Hurt Them*, Tax Notes (June 23, 2003) 1821; Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 Kans. L. Rev. 1145 (2003), available at [http://works.bepress.com/leslie\\_book/8](http://works.bepress.com/leslie_book/8); National Taxpayer Advocate 2002 Annual Report to Congress 50 (Most Serious Problem: *EITC Eligibility Determinations Can Be Made Less Burdensome*).

<sup>62</sup> The Initial Contact Letter (Letter 566) is the notification issued to inform a taxpayer that he or she is under correspondence audit and to detail the substantiation needed to resolve the issues under review.

status, while the other tests the impact of enhanced one-on-one telephone communication throughout the examination process.

According to a 2002 study of 1999 EITC returns, the most common reason the IRS disallows EITC is that taxpayers do not substantiate that their children lived with them for over half of the tax year.<sup>63</sup> In 2009, the IRS, with the assistance of TAS Research, began a three-year study to investigate whether the use of third-party affidavits can help claimants demonstrate the residency of qualifying children during audits. While current audit procedures allow taxpayers to provide either official records or letters on official letterhead to document the residence of a child, this pilot program gives the taxpayer the option of using another type of documentation — a third-party affidavit. This procedure allows third parties with knowledge of the child's residency to fill out a standardized affidavit rather than write a letter.<sup>64</sup> The objectives of this study are to answer the following questions:

- To what extent do affidavits reduce underclaims or increase overclaims?
- What percentage of taxpayers used affidavits to try to demonstrate residency of their qualifying children?
- How does the option of using the third-party affidavit affect the efficiency of the audit process?

In the second pilot program, TAS is working with the Wage and Investment (W&I) and Small Business/Self-Employed (SB/SE) divisions to test whether alternative approaches to conducting EITC correspondence examinations affects the audit change rate. Phase 1 of the program requires correspondence examiners to make telephone calls to test-group taxpayers at two points during the examination process: about ten days after the initial contact letter, and just prior to issuing the Statutory Notice of Deficiency.<sup>65</sup>

In Phase 2, taxpayers who did not retain all of their EITC and who did not agree to (or filed an appeal or protest of) their audit outcomes will be referred to TAS. TAS case advocates will then attempt to contact these taxpayers to help them through the process of proving eligibility for EITC. The goals of this phase are:

- To determine whether TAS assistance affects audit results;
- If so, to estimate the extent to which TAS assistance reduces overclaims or increases underclaims; and
- To complete this study by the end of July 2012.

<sup>63</sup> IRS, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns* 13 (Feb. 28, 2002).

<sup>64</sup> The IRS first tested the use of affidavits to establish residency of qualifying children on TY 2003 taxpayers who participated in a test of a proposed EITC certification process. Generally, this pilot program found affidavits more reliable than traditionally accepted documentation: "Affidavits were believed to be easier for taxpayers to obtain than official documents or letters. The results show that affidavits had a higher acceptance rate than the other two types of documents." See *IRS Earned Income Tax Credit (EITC) Initiatives: Report on Qualifying Child Residency Certification, Filing Status, and Automated Under-reporter Tests* 8, 14 (2008).

<sup>65</sup> See vol. 2, *Research Study: An Analysis of the IRS Examination Strategy: Proposals to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*, *infra*; see also National Taxpayer Advocate FY 2012 Objectives Report to Congress xxii (*EITC Examination Effectiveness*).

## CONCLUSION

The EITC has complex eligibility requirements that present administrative challenges to both taxpayers and the IRS. A delicate balance is required to encourage participation and at the same time promote compliance. Research studies on the struggles experienced by low income taxpayers have influenced and resulted in a number of initiatives that, *if properly implemented*, can improve EITC compliance and allow the IRS to refocus on other, potentially more productive audits. Lessons learned in EITC cases may help the IRS avoid mistakes with the administration of the health care premium tax credit, a new refundable credit for low income individuals.<sup>66</sup> An improved and effective EITC process could provide a starting point for the health care credit. Without such a process, the IRS will face additional challenges and costs in testing new systems for an expansive and complicated new credit.

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

1. Update the estimate of EITC improper payments, disclose the methodology utilized, and share the data and methodology with TAS and the general public;
2. Review proposals, especially those that apply math error authority, in light of the reliability (or unreliability) of external data as well as each taxpayer's right to present his or her own facts;
3. Finalize requirements that paid preparers inquire about taxpayer eligibility for the EITC, retain relevant information, and file a due diligence checklist with the return;
4. Use the revised Initial Contact Letter to clearly notify taxpayers that they are under correspondence audit; and
5. Fast-track the implementation of successful pilot and study recommendations (*e.g.*, affidavits and increased communication).

## IRS COMMENTS

The IRS administers a balanced Earned Income Tax Credit program with two strategic goals — to increase participation of eligible taxpayers and reduce erroneous payments. Our outreach and compliance efforts are directed to improving both of these goals. Each year we complete in-depth research studies to measure EITC participation and improper payments, based on the most recent data available.

The IRS is committed to assisting EITC taxpayers in understanding and fulfilling their tax obligations, while reducing taxpayer burden and protecting taxpayer rights. The IRS has developed a robust, multi-year communication strategy that leverages communication channels and marketing to increase EITC participation and provides resources to both taxpayers and preparers so that they can learn about EITC eligibility and preparer due

<sup>66</sup> IRC § 36B.

diligence requirements. This strategy includes public service announcements, along with the use of social media, the EITC Assistance tool on IRS.gov, the annual EITC Awareness Day, partnering with more than 300 community-based organizations and review of all filed returns for potential EITC eligibility. We also target the paid preparer community to address due diligence by conducting seminars at the Nationwide Tax Forums and access to the Tax Preparer Toolkit on our EITC Central website. Our research studies on participation, completed with the U.S. Census Bureau, show that EITC participation increased from 75 – 77 percent for tax year 2005 to 78 - 80 percent for tax year 2008.

In addition to ensuring eligible taxpayers receive EITC, the IRS also takes very seriously the need to prevent erroneous payments. The IRS employs a number of traditional enforcement tools in this area. In addition to examinations, our enforcement strategy includes traditional taxpayer treatments such as math error that corrected over 340,000 EITC claims and our underreporter program that addressed over 900,000 returns that underreported income. It also includes our soft notice program that solicits self-correction from 150,000 taxpayers annually.

The IRS recognizes, however, that we cannot address the error rate by traditional enforcement tools alone and continues to explore alternatives to address noncompliance. As the National Taxpayer Advocate's report indicated, the IRS's recent Tax Return Preparer Initiative is expected to have a significant impact on reducing EITC fraud and error. Preparers prepare over two-thirds of all EITC returns. The IRS is in the second year of this groundbreaking initiative, which includes requiring registration, testing and continuing education for tax return preparers. The new initiative also brings all return preparers under the ethical rules of Circular 230, which gives the IRS disciplinary tools in the case of preparer misconduct. More than 740,000 tax return preparers have registered since last year. New education and enforcement requirements are aimed at improving the accuracy of EITC returns that paid preparers file on behalf of their clients. The IRS is testing the effectiveness of various preparer treatments, including due diligence audits, educational visits, and letters. Preparers are also addressed through our criminal enforcement efforts.

The Administration's FY 2012 revenue proposals included an increase in the penalty imposed on paid preparers who fail to comply with the EITC due diligence requirements. The increase in the penalty from \$100 to \$500 per return was enacted in recent trade legislation, effective for returns due after December 31, 2011. As noted, the IRS is in the process of finalizing rules to require preparers to include the due diligence checklist with EITC returns. The IRS also formed an EITC Software Developers Working Group to collaborate on software enhancements and other efforts to help reduce EITC errors and assist preparers in meeting their EITC due diligence requirements.

The IRS employs a data-driven approach to identify and treat paid preparers who submit erroneous EITC claims. We continually strive to improve our preparer identification processes and test and evaluate new approaches to reduce erroneous EITC claims. As real-time

data becomes available, we will test and evaluate its use to improve our data driven model with goals of more effective and timely identification and treatment of noncompliant EITC return preparers. We also have been coordinating with Automated Underreporter (AUR) to identify EITC preparers with a high percentage of income mismatches based on information returns. After full implementation of the return preparer initiative, we will begin measuring its impact on EITC improper payments.

The IRS estimate of EITC improper payments is based on the most current information available — the current FY 2011 estimates are based on tax year 2007. The IRS improper payment estimates are based on the examination of a statistically valid sample of returns as part of the National Research Program (NRP). These audits are significantly different from the campus correspondence examinations referred to in the National Taxpayer Advocate's report. NRP audits are research audits, which mean the goal of the audits is to gather accurate information across multiple tax issues. More specifically, the NRP audits are primarily conducted face-to-face with taxpayers, not through correspondence; they are all post-refund; and the rate of non-response for these audits is closer to 15 percent rather than 70 percent referred to in the National Taxpayer Advocate's report. On the issue of non-response, it should be noted that the IRS improper payment estimate does not merely classify all no-shows as undeserving — instead we explicitly assume that many of these taxpayers would qualify for the credit.

The improper payment rate dropped from 26.3 percent in FY 2010 to 23.5 percent in FY 2011. This corresponds to a reduction from \$16.9 billion in FY 2010 to \$15.2 billion in FY 2011. While the reduction is significant, given that estimates are based on lagging audit data and that it is difficult to analytically pinpoint the exact cause of the reduction, the figure should be used cautiously.

The IRS appreciates the recognition of the continuing challenges faced by the EITC Program. The credit's eligibility rules are complicated, particularly the requirements to meet the relationship and residency tests. The complexity in applying these rules to common real-life situations is a challenge for both taxpayers and preparers and influences EITC error.

The IRS cannot independently validate whether taxpayers meet eligibility requirements for EITC. Reliable third-party data, however, can assist the IRS in compliance filters as well as in math error. In looking for new math error authority opportunities, the IRS considers accuracy and consistency of third-party data, administrative cost savings and efficiencies, compliance enhancements, simplicity and operational feasibility, as well as taxpayer rights and burden reduction.

The IRS recognizes the importance of clear communication and is working at improving notices sent to EITC taxpayers. In FY 2011, the IRS initiated revisions to the CP 75 notice series, *i.e.*, the initial contact letters used for most EITC audits. We anticipate the new

notices will be ready for use by 2013 and will provide taxpayers with a better understanding of the EITC audit process.

In the report, the National Taxpayer Advocate implies that IRS timeframes do not allow taxpayers enough time to provide documents to show EITC eligibility prior to the issuance of a Statutory Notice of Deficiency. The IRS does not believe that is the case. Taxpayers receive at least two notices requesting the documentation prior to the issuance of a SNOD. Besides stating the timeframe for responding, the notices also provide a telephone number for taxpayers to call with questions or if they need assistance. If a taxpayer requests additional time to provide documentation (either by telephone or written communication), the IRS has established procedures that give the taxpayer additional time to respond. Additionally, after a SNOD has been issued, the IRS continues to work with taxpayers and accepts any documents that verify a taxpayer is eligible for the EITC.

The IRS looks for opportunities to improve service to EITC taxpayers on a continuous basis. As the National Taxpayer Advocate discusses in the report, we are currently working with TAS on a three-year test to determine whether the use of third-party affidavits is another viable alternative that taxpayers may use to document the residency requirement. We are also working with TAS on another test on alternative processes for conducting correspondence exams.

The IRS offers the following comments with respect to the preliminary recommendations:

The IRS will continue its annual estimates of EITC improper payments using the most recent NRP data available. IRS will also continue to share that methodology with Treasury, OMB, oversight agencies and the public as it has in the past. The most recent figures are included in Treasury's Performance and Accountability Report (PAR) for FY 2011. Also, the NRP data used in the EITC improper payments estimate are available on the Research, Analysis and Statistics (RAS) Compliance Data Warehouse (CDW).

With respect to new proposals, we will continue to take into account the reliability of third-party data as well as taxpayers rights. While we plan to continue our efforts to identify new sources of information to verify EITC eligibility, math error candidates, and alternative compliance treatments to address EITC error, as with all strategic business decisions to achieve a balanced compliance program, we will consider the protection of taxpayer rights and impact on taxpayer burden as part of any new solutions.

As discussed, the IRS is in the process of finalizing changes to the EITC preparer due diligence requirements that were included in the proposed regulations issued on October 11, 2011. The proposed regulations include the requirement that paid preparers complete and submit Form 8867, *Paid Preparer's Earned Income Credit Checklist*, with every EITC tax return prepared. Under current requirements, preparers are required to keep a copy of the checklist for their records.

The IRS agrees that clear communication is important to inform taxpayers of an audit and help them understand what information they need to provide to resolve their audit issues. We have initiated revisions to CP 75 notice series, the initial contact letters used for most EITC audits. We anticipate the revised notices will be available for use by January 2013.

Finally, with respect to the proposal to fast-track implementation of pilots, after pilots are complete, we will carefully evaluate the results and recommendations. We will review the successes and best practices of the studies, consider operational implications, and roll them out as appropriate.

### Taxpayer Advocate Service Comments

The National Taxpayer Advocate commends the IRS's efforts to improve EITC service and compliance, and welcomes the opportunity for continued collaboration on innovations such as the affidavit and examination pilot programs. However, the National Taxpayer Advocate finds several aspects of the IRS's response to be troubling.

The response above states that the "IRS cannot independently validate whether taxpayers meet eligibility requirements for EITC." Yet IRS validation of taxpayer eligibility is the core of tax administration. Consequently, this statement appears to be a startling abdication of government responsibility. While external data may be a useful *indicator*, the National Taxpayer Advocate questions whether that data can ever substitute for a careful review of facts that a taxpayer may present.

Data-driven approaches are only as good as the underlying data, which must withstand rigorous public and professional peer review. It is unclear if the 23.5 percent improper payment rate based on NRP "research audits" reflects the reality of the EITC, for which many taxpayers undergo correspondence examinations. According to the IRS, the non-response rate for face-to-face audits is 15 percent, compared with 70 percent for correspondence examinations. If so, this confirms that the type of audit drastically affects the outcome. Moreover, the difference between the 15 and 70 percent non-response rates suggests that correspondence examination should not be the primary EITC compliance tool, as it depends on a taxpayer's ability to navigate the particular exam process that the IRS offers.

Additionally, the IRS states that the "improper payment estimate does not merely classify all no-shows as undeserving – instead we explicitly assume that many of these taxpayers would qualify for the credit." It is difficult to suggest improvements to the methodology behind the estimation of improper payments without knowing the underlying assumptions. Accordingly, it is in the best interest of tax administration to share these assumptions as well as data for reevaluation of the estimates.

For that matter, key aspects of data and methodology remain shrouded in obscurity. The IRS response above references the Treasury's FY 2011 Performance and Accountability Report, yet it is unclear that this report addresses EITC.<sup>67</sup> On the other hand, improper payments are discussed in Appendix B of Part 3 of the Agency Financial Report.<sup>68</sup> Consequently, it is difficult to verify the IRS response. While this response states that the relevant data are in the CDW, an all-encompassing IRS database not accessible by the public, the IRS comments above also mention a Census research study, without citing a specific title. Again, it would be a challenge to confirm these assertions, leaving the 1999 study as the last publication to have revealed assumptions, data, and methodology that illuminated a complete picture of EITC compliance.<sup>69</sup> The IRS response states that the improper payment rate dropped from 26.3 to 23.5 percent from FY 2010 to 2011. Would these figures be comparable to the range of 27.0 to 31.7 percent reported in the 1999 study?<sup>70</sup> Taxpayers, Congress, and the public deserve full disclosure to make informed decisions.

The National Taxpayer Advocate commends the IRS on outreach to the target population and their preparers. The National Taxpayer Advocate has long championed regulation of preparers, particularly because it should improve EITC compliance. We encourage the IRS, after finalizing proposed regulations that require preparers to file a due diligence checklist with the return after reviewing and retaining eligibility information, to implement regulations that will expand the scope of what preparers must inquire about and review in order to fulfill their EITC due diligence requirements. At the same time, we encourage the IRS to use plain-language form letters that EITC taxpayers can easily read and understand. Until the IRS provides clear communication, taxpayers may continue to misunderstand requirements and miss deadlines, even if the IRS considers them sufficient (and sufficiently clear).

<sup>67</sup> See <http://www.treasury.gov/about/organizational-structure/offices/Mgt/Documents/Full%20Report%20of%20the%20Treasury%20Department.pdf> (last visited Dec. 19, 2011).

<sup>68</sup> See <http://www.treasury.gov/about/budget-performance/annual-performance-plan/Documents/FY%202011%20AFR-%20Part3.pdf> (last visited Dec. 19, 2011).

<sup>69</sup> See IRS, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns* (Feb. 28, 2002).

<sup>70</sup> *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns at 3* ("Of the estimated \$31.3 billion in Earned Income Tax Credit (EITC) claims made by taxpayers who filed returns in 2000 for tax year 1999, it is estimated that between \$8.5 and \$9.9 billion (27.0 percent to 31.7 percent) should not have been paid.").

## Recommendations

In conclusion, the National Taxpayer Advocate is pleased that the IRS response above seems generally consonant with her recommendations, but emphasizes that these key items should not be glossed over. The IRS should:

1. Prepare and disclose a full report on its current and prior EITC noncompliance studies, similar to that reporting on 1999. Among other things, this report should disclose assumptions within the methodology as well as data for continued update of the EITC improper payment estimate, which needs to become transparent in light of policies it may generate.
2. Utilize external data only as an indicator for the risk of noncompliance, so that taxpayers retain their right to have an opportunity to present his or her own facts, a right not subject to compromise by an IRS business decision.
3. Send correspondence in plain language by implementing the revised Initial Contact Letter (Letter 566) and beginning revision of the other high-volume letters used in correspondence examinations as discussed above by January 2013.

MSP  
#15**Reinstatement of a Modernized TeleFile Would Reduce Taxpayer Burden and Benefit Tax Administration****RESPONSIBLE OFFICIALS**

Beth Tucker, Deputy Commissioner-Operations Support  
 Julie Rushin, Deputy Chief Information Officer for Operations  
 Richard E. Byrd Jr., Commissioner, Wage and Investment Division

**DEFINITION OF PROBLEM**

The reinstatement of a modernized version of TeleFile would provide individual and small business taxpayers with a free, convenient government method of filing electronically. The program, which the IRS shut down in 2005, allowed taxpayers who filed relatively simple returns and met specific requirements to file by touch-tone telephone. The end of this program left a segment of the taxpaying population, including both individuals and small businesses, with no convenient way to file electronically at no cost.<sup>1</sup> In fact, the IRS's elimination of TeleFile and refusal to revive an expanded Telefile program has an economically and racially discriminatory impact.<sup>2</sup> Although the IRS expected TeleFile users to convert to other e-filing methods, nearly 30 percent of former TeleFile users instead filed paper returns in 2008.<sup>3</sup> By creating a 21<sup>st</sup> century version of the Telefile application, the IRS can take advantage of the surge in demand for services delivered through smartphone and cell phone technology. In fact, approximately 83 percent of American adults own a cell phone and approximately 35 percent own a Smartphone.<sup>4</sup> Telefile can then serve as a bridge to full electronic filing after taxpayers migrate from the program.

**ANALYSIS OF PROBLEM****Background**

In 1996, the IRS launched the nationwide TeleFile, which allowed eligible taxpayers to file returns using the keypads on their phones. TeleFile, which was then the only electronic filing method offered directly by the IRS, was promoted as the most convenient, quickest, and simplest way to file. By 2005, taxpayers could file the Form 1040EZ, *Income Tax Return*

<sup>1</sup> In addition to providing individuals with a free method to electronically file Form 1040EZ, *Income Tax Return for Single and Joint Filers With No Dependents*, and 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*, TeleFile was the only free way to electronically file Forms 941, *Employer's Quarterly Federal Tax Return*. Thus, the decision to terminate TeleFile also increased the compliance burden of some small businesses.

<sup>2</sup> The results of a Pew Internet & American Life Project Survey from May 2011 indicate a significant decrease in Internet use as age increases, along racial lines, as education levels decrease, and as annual household income level decreases. The survey was conducted by telephone and 755 of the 2,277 respondents used their cell phones to respond to the interviews (the remaining used land-line telephones). U.S. Census Bureau, *Statistical Abstract of the United States: 2012, Information and Communications, Table 1158, Adult Computer and Adult Internet Users by Selected Characteristics: 2000 to 2011*.

<sup>3</sup> National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 125-156 (*TeleFile - Taxpayers' Characteristics and Filing Behaviors: A Study to Enhance Taxpayer Assistance Blueprint Knowledge*).

<sup>4</sup> Aaron Smith, Pew Internet and American Life Project, *Americans and Their Cell Phones: Mobile Devices Help People Solve Problems and Stave Off Boredom, but Create Some New Challenges and Annoyances* 2, 3 (Aug. 15, 2011).

for *Single and Joint Filers With No Dependents*, certain state individual returns, Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return*, and Form 941, *Employer's Quarterly Federal Tax Return*. On average, the program was used by 4.4 million taxpayers annually and had a satisfaction rate of over 90 percent, the highest of all filing options in 2004.<sup>5</sup> In fact, the initial success of the program led Congress to mandate that “the IRS should continue to offer and improve its TeleFile Program and make a comparable program on the Internet.”<sup>6</sup> In March 2003, the Treasury Inspector General for Tax Administration (TIGTA) suggested the IRS make TeleFile accessible to even more taxpayers. Instead, in 2004 the IRS Electronic Tax Administration Advisory Committee (ETAAC) recommended that the IRS eliminate the program and redirect the funds to the Modernized e-file Project.<sup>7</sup> In August 2005, the IRS discontinued TeleFile, citing the following reasons:

- Increasing costs;
- Declining use;
- Discontinued state telefile programs; and
- Growth of other electronic filing options.<sup>8</sup>

#### **The IRS's Decision to Terminate TeleFile Was Unjustified.**

The National Taxpayer Advocate believes that the IRS should not have terminated the TeleFile program. In fact, the IRS stopped publicizing it and narrowly defined the user population, but then claimed the cost per return was too high. However, the cost to run the program is a fixed contract cost, so the cost per return will increase as the participation rate decreases. Thus, by failing to publicize the program, the IRS increased the cost per return. Before terminating the program, the IRS did not give due consideration to ways to broaden the base of eligible taxpayers to reduce the cost per return. Further, it did not explore ways to modify the program to meet the changing needs of taxpayers. Because of the IRS's decision, millions of individuals and small businesses had to find other ways to prepare their returns – and many reverted to paper or used paid preparers.<sup>9</sup>

#### **Low Usage of TeleFile Was the Result of Eligibility Restrictions.**

The IRS cited declining usage as a reason to discontinue TeleFile. While use steadily decreased between 1998 and the end of the program, the number of taxpayers eligible to use

<sup>5</sup> TIGTA, Ref. No. 2007-40-116, *Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers 1* (July 20, 2007). For tax year (TY) 2004, TeleFile accounted for over 800,000, or nearly 19 percent of electronically-filed Form 941 returns, *Employer's Quarterly Federal Tax Return*. SB/SE Research, *FY 2005 Nationwide Analysis, Electronic Tax Administration Business Master File Marketing Database*, Slide 9 (June 2005).

<sup>6</sup> H.R. Conf. Rep. No. 105-599 at 235 (1998); TIGTA, Ref. No. 2007-40-116, *Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers* (July 20, 2007).

<sup>7</sup> Electronic Tax Administration Advisory Committee 2004 Annual Report to Congress 8 (June 30, 2004).

<sup>8</sup> IRS, Announcement 2005-26: *IRS to Discontinue TeleFile*, Internal Revenue Bulletin 2005-17 (Apr. 25, 2005); TIGTA, Ref. No. 2007-40-116, *Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers 2* (July 20, 2007).

<sup>9</sup> TIGTA, Ref. No. 2007-40-116, *Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers 5, 6* (July 20, 2007).

the program steadily declined as well.<sup>10</sup> In fact, the percentage of eligible taxpayers who used the program remained fairly constant (an average percentage of almost 45 percent between 1998 and 2005 with the last year at 41.7 percent).<sup>11</sup> Thus, the reduced participation was not necessarily a result of taxpayer preferences, but rather the restrictive eligibility requirements. These requirements included an income and interest threshold, no dependents, age, filing status, disability, no paid preparer use, and address change limitations. Taxpayers also had to receive a TeleFile tax package, which the IRS would mail based on the return filed the previous year. However, taxpayers' circumstances change and ineligibility in one year does not necessarily lead to ineligibility in the next. Thus, the IRS should have explored the feasibility of expanding the requirements and making packages available to previously ineligible taxpayers before terminating the program based on low usage and increasing costs.

In a 2010 study, the Taxpayer Advocate Service Research Office estimated that approximately eight million taxpayers would be eligible for TeleFile if the 2005 eligibility criteria remained constant.<sup>12</sup> If the IRS modified the limitation on moving, it could add about two and a half million taxpayers to the base. If the IRS modified several eligibility restrictions, it could increase participation by as much as 27 million, about a third of which would switch from paper filing.<sup>13</sup>

#### **A Significant Portion of Former TeleFile Users Reverted to Paper Filing.**

The IRS developed TeleFile as a gateway from paper to electronic filing. Therefore, it is no surprise that studies by both TIGTA and TAS found that a considerable percentage of former TeleFile users reverted to paper filing rather than move to another electronic method as anticipated. When reverting to paper, taxpayers lose the benefits of e-filing, including faster refunds and more accurate transcription. In addition, the elimination of TeleFile may have caused some of these taxpayers to purchase commercial refund delivery products with high associated fees. TIGTA found that almost 966,000 (or approximately 48 percent) of the former users who would have remained eligible to use the program in 2006 reverted

<sup>10</sup> TIGTA, Ref No 2007-40-116, *Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers* Figure 6 (July 20, 2007.)

<sup>11</sup> The percentage of eligible taxpayers using TeleFile by year: 40.8 percent in 1998, 41.2 percent in 1999, 40.8 percent in 2000, 47.5 percent in 2001, 54.6 percent in 2002, 47.4 percent in 2003, 45.9 percent in 2004, and 41.7 percent in 2005 (the year the program ended). TIGTA, Ref. No. 2007-40-116, *Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers*, Figure 6 (July 20, 2007).

<sup>12</sup> Similarly, in 2005, approximately 7.9 million taxpayers were eligible to use TeleFile and approximately 3.3 million returns were filed in 2005 using TeleFile. In comparison, total Free File usage (including Free File and Free File Fillable Forms) was approximately 3.17 million in 2011, which is down from nearly 3.25 million in 2010. IRS, Daily E-File At-a-Glance, U.S. Totals for Individual Returns, ELF1505 (Oct. 25, 2011); TIGTA, Ref. No. 2007-40-116, *Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers*, Figure 6 (July 20, 2007).

<sup>13</sup> National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 146 (*TeleFile – Taxpayers' Characteristics and Filing Behaviors: A Study to Enhance Taxpayer Assistance Blueprint Knowledge*). In January 2004, the IRS enhanced the TeleFile system to allow taxpayers who moved to an address different than that on their TeleFile tax package to use TeleFile if they used direct deposit for their refund. IRS Seven-Day Response to MSP on Low Usage of Telefile (Nov. 16, 2011). However, taxpayers needed to be in possession of the package in order to use TeleFile and packages were not forwarded in the mail. Thus, in order to be in possession of the package, the taxpayer needed to either (1) move after receiving the package but before filing the return or (2) inform the IRS of the new address before the packages were mailed.

to paper.<sup>14</sup> TAS also found that they continued to file by paper for at least several years after TeleFile ended, and nearly 30 percent filed paper returns in 2008.<sup>15</sup>

It is in the best interest of tax administration to steer taxpayers toward electronic filing. TeleFile affords the agency and taxpayers many of the same advantages as traditional e-file. Telefile was simple; available 24 hours a day, seven days a week; allowed for quick refund turnaround time; and provided a filing acknowledgement. Not every household has the required computer or Internet access for standard e-file. A recent Pew Internet Project survey showed that approximately one in four adults does not use the Internet. However, a U.S. Census Bureau American Community Survey found that nearly 98 percent of U.S. households have some type of telephone service.<sup>16</sup>

#### **Many Former TeleFile Users Paid Significant Preparation Fees.**

TeleFile was one of only two ways available to taxpayers to electronically file at no cost and was the *only* free e-file method provided directly by the federal government. TIGTA estimated that of approximately two million individual taxpayers who used TeleFile in 2005, more than 541,000 taxpayers paid \$23.6 million to file in 2006 after the program ended. In effect, when the IRS eliminated TeleFile, it shifted its costs to taxpayers. The IRS expected to save between \$17 million and \$23 million by retiring the program, but TIGTA estimated the former users paid approximately \$23.6 million to file in 2006.<sup>17</sup>

#### **A Modernized Version of TeleFile Would Leverage the Surge in Demand for Services Provided via Smartphone and Cell Phone Technology.**

Taxpayers are increasingly using cell phone technology to receive services. An August 2011 report by the Pew Internet & American Life Project found approximately 83 percent of American adults own a cell phone and 35 percent own a smartphone. Interestingly, approximately 15 percent use their cell phones for online banking.<sup>18</sup> To take advantage of these developments, many financial institutions offer smartphone applications that allow customers to identify account balances, move funds between accounts, pay bills, and receive notifications or alerts. Approximately 15 percent use their cell phones for online banking.<sup>19</sup> Banks actually realize savings by providing such technology, as the cost of a

<sup>14</sup> TIGTA, Ref. No. 2007-40-116, *Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers* 6 (July 20, 2007).

<sup>15</sup> National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 141 (*TeleFile – Taxpayers’ Characteristics and Filing Behaviors: A Study to Enhance Taxpayer Assistance Blueprint Knowledge*).

<sup>16</sup> Pew Internet & American Life Project, Pew Research Center, *Internet, Broadband, and Cell Phone Statistics* 2, 7 (Jan. 5, 2010); U.S. Census Bureau, 2009 American Community Survey 1-Year Estimates, Table C25043.

<sup>17</sup> TIGTA, Ref. No. 2007-40-116, *Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers* 2, 5 (July 20, 2007). In addition, in the year after the TeleFile program was terminated, the IRS required over 640,000 business taxpayers to file Form 944 annually instead of filing a quarterly Form 941. While the 944 program was intended to reduce taxpayer burden, it actually caused confusion as well as many unpostable returns and payments. Thus, many taxpayers were no longer allowed to use TeleFile and were immediately thereafter mandated to use a program that increased burden for both taxpayers and the IRS. 2008 IRPAC Report, Burden Reduction Subgroup Report 1.

<sup>18</sup> Aaron Smith, Pew Internet and American Life Project, *Americans and Their Cell Phones: Mobile Devices Help People Solve Problems and Stave Off Boredom, but Create Some New Challenges and Annoyances* 2, 3 (Aug. 15, 2011).

<sup>19</sup> *Id.* at 5.

smartphone or online transaction is typically two percent or less of the cost of one conducted by a traditional customer service representative.<sup>20</sup>

The IRS recognized the popularity of phone-based applications when it developed such smartphone applications as “IRS2Go,” which includes the popular program “Where’s My Refund?” It also provides the subscriber with the option to receive daily tax tips. The IRS launched the application in late January 2011 and by April 12, 2011, it had already been downloaded over 250,000 times.<sup>21</sup>

The private sector also offers a smartphone-based tax preparation program, TurboTax’s SnapTax, which allows taxpayers to file 1040EZ returns on a smartphone for approximately \$20.<sup>22</sup> By modernizing TeleFile to include smartphone technology, the IRS would not be competing with the private sector. It would merely provide a “plain vanilla” return filing platform without the costs of additional options that attach to commercial products. This new technology should include an option to send text notifications and alerts to subscribers, because the IRS would perform a valuable service by notifying or alerting taxpayers about their returns and refund status, as well as offering tax tips.

Finally, the IRS should evaluate the strengths and weaknesses of existing phone-based products available in the private sector as well as other government agencies and jurisdictions.<sup>23</sup> The IRS is certainly not the leader in this technology and could benefit from lessons learned by those who have already developed these products.

#### **The Expansion of Eligibility Requirements Would Increase Participation.**

Considering that TeleFile is a bridge technology to standard e-filing, the IRS should try to cover as many paper filers as possible when developing eligibility requirements for a new version. Even if it costs marginally more to process a return through TeleFile, the IRS would achieve years of downstream savings by converting paper filers to permanent e-filers. As the returns filed by TeleFile users become more complicated, they will become ineligible for the program. After having used TeleFile in the past, these “graduated” former users will be more comfortable filing through electronic means, will be less likely to revert back to paper, and will likely be more open to using software packages to prepare their own returns.

As mentioned previously, TAS Research analyzed the impact of changing various eligibility restrictions and how each variable would impact usage. We encourage the IRS to review

<sup>20</sup> *Smartphone Usage Creates Opportunities for Many, Including Attevo, Inc.*, PR Newswire (July 1, 2011).

<sup>21</sup> IRS News Release, IR-2011-41, *IRS Reminds Taxpayers to Use the IRS2Go App to Check Refunds; Downloads Top 250,000* (Apr. 12, 2011).

<sup>22</sup> See <http://turbotax.intuit.com/snaptax/mobile> (last visited Aug. 17, 2011).

<sup>23</sup> Some states use phone-based programs to collect business, sales/use, and property taxes. Canada uses a phone-based system called TELEFILE for individual income taxes. See <http://www.cra-arc.gc.ca/esrvc-srvce/tx/ndvdl/tf/bt-eng.html> (last visited Aug. 17, 2011). For an example of a local government jurisdiction using smartphone technology for property taxes, see <http://portal.arkansas.gov/services/Pages/servicesMobile.aspx> (last visited Oct. 25, 2011).

TAS's research to design eligibility requirements to maximize participation. Examples of requirements that the IRS might modify are (1) the requirement that the taxpayer receive the TeleFile package from the IRS beforehand, (2) income limits, and (3) the restriction on moving.<sup>24</sup>

## CONCLUSION

Reinstating and upgrading the TeleFile program would meet the needs of taxpayers who are relying more and more on phone-based technology. A modernized TeleFile would provide free electronic filing to both individuals and small businesses on a widely accessible platform. To increase participation and its effectiveness as a bridge technology to standard e-filing, an expansion of TeleFile eligibility requirements and a marketing campaign are necessary.

To reduce taxpayer burden and meet the needs of taxpayers as well as tax administration, the National Taxpayer Advocate preliminarily recommends that the IRS take the following actions:

1. Reinstatement of TeleFile with expanded eligibility requirements, including allowing taxpayers who move to use the system and increasing income thresholds.
2. Develop modern applications of TeleFile suitable for current technology, such as cell phones, smartphones, and tablets.

## IRS COMMENTS

TeleFile was developed in 1996 as an early initiative to move taxpayers, and the IRS, to a paperless tax filing system. This system provided an alternative to some taxpayers resistant or unable to have their taxes filed electronically. As electronic filing increased, TeleFile experienced a decline in participation that continued until the program was discontinued in August 2005.

The IRS discontinued TeleFile because of the decline in usage and high cost to maintain relative to other filing channels. Based on estimates, TeleFile volumes would have had to nearly triple in order to be cost-competitive. Moreover, TeleFile was more expensive than electronic filing at all achievable volumes.

The decline in usage of TeleFile was primarily due to a decrease in Form 1040EZ filings, which comprised 72 percent of the total TeleFile filings. While volumes for TeleFile of Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Tax Return*, increased, it was not sufficient to offset the overall decline. In January 2004, the IRS allowed taxpayers who moved to a new address to use TeleFile if they directly deposited their

<sup>24</sup> National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 145-146, 151 (*TeleFile – Taxpayers' Characteristics and Filing Behaviors: A Study to Enhance Taxpayer Assistance Blueprint Knowledge*).

refund into a checking or savings account. This change was not sufficient to offset the decline in Form 1040EZ volumes.

The Free File program has been available as an alternative to TeleFile since August 2005. In 2011, Free File was available to taxpayers with an adjusted gross income of \$58,000 or less. The estimated number of taxpayers eligible to use this free tax preparation and e-filing service is approximately 96 million. Over 33 million federal returns have been filed using Free File since its inception.

In addition, starting in 2009, all filers became eligible to use Free File Fillable Forms, a free federal tax preparation and e-file service available to all taxpayers regardless of income. Other free filing options include Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE). Private industry also offers free Form 1040EZ e-filing services in the marketplace.

When the decision was made to discontinue TeleFile, the future stated vision for IRS Submission Processing was to tailor acceptance channels for efficiency and cost-effectiveness. The backbone of the acceptance process is a single pipeline, Modernized e-file (MeF) in conjunction with CADE2, for capturing data from paper and electronic submissions.

With regard to business returns, a Small Business e-file Communication Team is leading a cross-functional communication effort to increase the visibility and promotion of business e-file, including the Form 94x series and the Form 1120. While there are no free options as there are with individual Free File, the IRS is looking at IRS.gov, publications, and other outlets to inform businesses of the availability and value of e-file. The IRS Office of Online Services (OLS) is looking at various options for increasing Form 941 e-file and online payments.

The IRS does not believe that it is appropriate to reinstate TeleFile at this time. Free File and Free Fillable forms are available as free preparation and e-filing options for simple returns. These alternatives have assisted the IRS in receiving nearly 80 percent of Forms 1040 electronically. Reinstating TeleFile would cost the government and taxpayers millions annually to support and maintain. To the extent resources allow the development of modern applications suitable for current technology, such as cell phones, smart phones, and tablets, we anticipate that such technology would support our current electronic filing system rather than the retired TeleFile program.

## Taxpayer Advocate Service Comments

While the National Taxpayer Advocate understands the IRS's need to encourage traditional electronic filing to realize many of the associated benefits, including reduced return processing costs, she is disappointed by the IRS's short-sighted response to our concerns. Volunteer tax return preparation services, as well as Free File and Free File Fillable Forms, are free options for taxpayers with relatively simple returns.<sup>25</sup> However, the IRS should not eliminate a return preparation and filing program with the expectation that volunteer preparers will absorb a substantial portion of the program's former users. Further, for those who wish to prepare their own returns, electronic filing is not an option if they do not use the Internet, which is still an issue in a significant percentage of U.S. households. In fact, Census Bureau data show that over 31 percent of all U.S. "householders" did not use the Internet at home in 2009.<sup>26</sup> In comparison, a Census Bureau American Community Survey found that nearly 98 percent of households had some type of telephone service in 2009.<sup>27</sup> In addition, an August 2011 report by the Pew Internet & American Life Project found that approximately 83 percent of American adults own a cell phone and 35 percent own a smartphone.<sup>28</sup> In fact, 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.<sup>29</sup>

The IRS states that any potential future application suitable for current technology, such as cell phones, smartphones, or tablets, should support the current electronic filing system rather than the retired TeleFile. We support this statement. The IRS does not necessarily need to base a new system on the retired one. If the IRS chooses to start with a completely different platform that uses cell phone, smartphone, and tablet technology, it would accomplish the same goal – a self-assisted preparation and filing application using phone-based

<sup>25</sup> Total Free File usage (including Free File and Free File Fillable Forms) was approximately 3.17 million in 2011, which is down from nearly 3.25 million in 2010. IRS, Daily E-File At-a-Glance, U.S. Totals For Individual Returns, ELF1505 (Oct. 25, 2011).

<sup>26</sup> U.S. Census Bureau, Current Population Survey (Oct. 2009), Table 1, *Reported Internet Usage for Households, by Selected Householder Characteristics: 2009* (Feb. 2010). In nearly 25 percent of households no one living in the household used the Internet at all. The percentage of households that do not use the Internet at home increases to over 41 percent for householders aged 55 or older, over 45 percent for African-American householders, over 47 percent for Hispanic householders, and over 67 percent for those who attained less than a high school degree. "Householder" is defined as the person (or one of the people) in whose name the housing unit is owned or rented.

<sup>27</sup> U.S. Census Bureau, 2009 American Community Survey 1-Year Estimates, Table C25043.

<sup>28</sup> Aaron Smith, Pew Internet and American Life Project, *Americans and Their Cell Phones, Mobile Devices Help People Solve Problems and Stave Off Boredom, but Create Some New Challenges and Annoyances* 2, 3 (Aug. 15, 2011).

<sup>29</sup> The results of a Pew Internet & American Life Project Survey from May 2011 indicates a significant decrease in Internet use as age increases (42 percent of adults 65 years and older as compared to 74 percent of those aged 50 to 64 years old), along racial lines (67 percent of Black, non-Hispanic adults as compared to 79 percent White, non-Hispanic adults), as education levels decrease (42 percent of adults with less than a high school degree compared to 94 percent college graduates or higher), and as income level decreases (63 percent of adults with annual household income of \$30,000 or less as compared to 96 percent of adults in households with annual household income of \$75,000 or more). Interestingly, the survey was conducted by telephone and 755 of the 2,277 respondents used their cell phones to respond to the interviews (the remaining used land-line telephones). U.S. Census Bureau, Statistical Abstract of the United States: 2012, Information and Communications, Table 1158, *Adult Computer and Adult Internet Users by Selected Characteristics: 2000 to 2011*.

technology available to both individual and business taxpayers. We note that the IRS itself is developing smart phone applications for both its current and future platforms.

The IRS also states that its expansion of eligibility requirements in 2004 failed to increase participation to meaningful levels. At that time, the IRS allowed taxpayers who moved to use TeleFile if they direct deposited their refund. However, it is our understanding that the IRS still required taxpayers to have the TeleFile package in order to use the program, and that the postal service did not forward these packages. Thus, taxpayers who moved could only use the program if they changed their addresses with the IRS before the packages were mailed or if they moved after they received the packages. This point is important because it significantly limits the number of taxpayers who moved in the past year and would still be eligible to use the program.

We understand that the cost per return filed under the former TeleFile system was more expensive than e-file. However, this cost is driven by the number of users – which was limited by the IRS’s restrictive participation criteria. Nearly 30 percent of former TeleFile users reverted back to paper filing for at least several years after the program was retired.<sup>30</sup> While the ultimate goal should be to steer all taxpayers to electronic filing, we cannot ignore the fact that a certain portion of taxpayers will choose paper over electronic filing and a sizable portion of the population does not have Internet access or is not computer savvy. The IRS could target remaining paper filers with a preparation and filing program that uses modern phone-based technology as a platform – whether it is a modernized version of the former TeleFile or a completely new program. The TAS 2010 TeleFile Study provides suggestions on how to expand eligibility requirements in order to increase usage and reduce the cost per return.<sup>31</sup>

In its response, the IRS acknowledges the absence of a free convenient method for small businesses to file Form 94x series returns and make payments. However, informing and directing these taxpayers to business e-file is not sufficient, because small businesses will need to pay for software or online preparation. 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.

<sup>30</sup> National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 141 (*TeleFile – Taxpayers’ Characteristics and Filing Behaviors: A Study to Enhance Taxpayer Assistance Blueprint Knowledge*).

<sup>31</sup> *Id.* at 146.

## Recommendations

The National Taxpayer Advocate recommends that the IRS takes the following actions:

1. Reinstatement of TeleFile with expanded eligibility requirements, including allowing taxpayers who move to use the system and increasing income thresholds.
2. Develop modern applications of TeleFile suitable for current technology such as cell phones, smartphones, and tablets.
3. 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.

MSP  
#16**The IRS Does Not Sufficiently Recognize and Address Domestic  
Violence and Abuse and its Effects on Tax Administration****RESPONSIBLE OFFICIALS**

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 Debra Chew, IRS Human Capital Officer  
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**DEFINITION OF PROBLEM**

Approximately 1.3 million women and 835,000 men are physically assaulted by an intimate partner each year in the United States.<sup>1</sup> Nearly three out of four Americans know someone who is or has been a victim of domestic violence.<sup>2</sup> The problem is no respecter of age, gender, race, ethnicity, income, or occupation; it is a means by which an abuser exercises control over his or her victim.

Domestic violence and abuse, including economic abuse, have real consequences for tax administration. This includes joint returns signed under duress, joint returns signed without any possibility of meaningful review, and an array of tax noncompliance or frivolous litigation by an abuser that implicates the victim but which the victim is powerless to prevent. Identity theft, with all the tax consequences that flow from it, may itself be a form of domestic abuse, and abusive partners may use the IRS to inflict abuse on their victims. The dysfunctions caused by domestic violence and abuse can make the IRS unwittingly complicit in achieving the wrong result — imposing or collecting tax inappropriately, or from the wrong taxpayer. Conversely, the IRS, by achieving the correct tax result, may actually alleviate the economic harm perpetrated by the abuser.

The obstacles that prevent the IRS from effectively dealing with taxpayers who are victims of domestic abuse are:

- A lack of awareness and training, which may cause employees to misinterpret taxpayer responses or not solicit relevant information;
- Document-oriented systems and expectations, which may cause employees to overlook the availability of reliable information that would lead to the correct resolution of tax matters; and

<sup>1</sup> Dept. of Justice, *Full Report of the Prevalence, Incidence, and Consequences of Violence Against Women, Findings from the National Violence Against Women Survey* (July 2000) iv, available at <http://www.ncjrs.gov/pdffiles1/nij/183781.pdf>. The definition of intimate partner includes current or former spouses, opposite-sex cohabiting partners, same-sex cohabiting partners, boyfriends/girlfriends, and dates.

<sup>2</sup> Allstate Foundation *What is Domestic Violence?* (2011), available at <http://www.allstatefoundation.org/about-domestic-violence>.

- A lack of information available to IRS employees and in the literature and resources the IRS distributes to the public.

## ANALYSIS OF PROBLEM

### Background

One in every four women will experience violence at the hands of an intimate partner in her lifetime.<sup>3</sup> Women of all races are about equally vulnerable to violence by an intimate partner, and intimate partner violence affects people regardless of income.<sup>4</sup> Approximately 450,000 elderly persons in domestic settings were abused or neglected during 1996.<sup>5</sup>

Physical violence is one of the most recognizable forms of domestic violence. However, abusers also often use money as a tool to exercise control and ensure financial dependence, which in turn often forces victims to remain in violent situations.<sup>6</sup> Economic abuse takes many forms, but typical fact patterns include an abuser who restricts the victim's knowledge about and access to family finances, forbids the victim from handling money or incurring expenses, or allots the victim's daily expenses and requires the victim to account for every penny.<sup>7</sup> The abuser may deprive the victim of access to credit cards or banking services, take control of the victim's earnings, or prevent or limit employment. By stealing the victim's identity and damaging her or his credit, or filing joint tax returns that give rise to joint and several liability, an abuser can extend the effects of the abuse far into the future.<sup>8</sup> A taxpayer who interacts with the IRS from a position of near-total ignorance of her or his tax filing and payment history, with no control over what was done in her or his name, is at a serious disadvantage.<sup>9</sup> Paradoxically, the victim, particularly one who has been victimized for a long time, may underestimate the frequency and severity of the abuse.

<sup>3</sup> National Coalition Against Domestic Violence *Fact Sheet* (July 2007).

<sup>4</sup> See Bureau of Justice Statistics, *Violence Against Women: Estimates from the Redesigned National Crime Victimization Survey*, Aug. 1995, table 6, available at <http://bjs.ojp.usdoj.gov/index.cfm?ty=pbdetail&iid=805>.

<sup>5</sup> The National Center on Elder Abuse at The American Public Human Services Association in Collaboration with the Westat, Inc., *The National Elder Abuse Incidence Study* (1998) 1, available at [http://www.aoa.gov/AoARoot/AoA\\_Programs/Elder\\_Rights/Elder\\_Abuse/docs/ABuseReport\\_Full.pdf](http://www.aoa.gov/AoARoot/AoA_Programs/Elder_Rights/Elder_Abuse/docs/ABuseReport_Full.pdf).

<sup>6</sup> The most likely predictor of whether a victim will permanently separate from the abuser is whether the victim has the economic resources to survive without the abuser. Three critical ingredients of economic independence for victims are: income from a source other than the abuser; adequate transportation; and sufficient childcare arrangements. Barbara J. Hart, *The Legal Road to Freedom*, Minnesota Center Against Violence and Abuse (1991), available at <http://www.mincava.umn.edu/documents/hart/hart.html>.

<sup>7</sup> See Summary of Workshop Proceedings: *Exploring the Intersection between Financial Capability and Domestic Violence*, Center for Financial Security (2011) (recounting events on May 17, 2011, when the U.S. Dept. of the Treasury, the Social Security Administration, and the University of Wisconsin – Madison's Center for Financial Security hosted an event with the goal of bringing together government officials, academic researchers, domestic violence practitioners and policy makers to explore how personal financial capability relates to domestic violence), available at [http://cfs.wisc.edu/DV\\_Workshop/Gjertson\\_Issue\\_Brief.pdf](http://cfs.wisc.edu/DV_Workshop/Gjertson_Issue_Brief.pdf); see also *Stephenson v. Comm'r*, T.C. Memo. 2011-16, discussed *infra*; *Thomassen v. Comm'r*, T.C. Memo. 2011-88, discussed *infra*.

<sup>8</sup> Financial or material exploitation, defined as the illegal or improper use of an elder's funds, property, or assets, accounted for 30.2 percent of all *substantiated* reports of elder maltreatment in 1996. The National Center on Elder Abuse at The American Public Human Services Association in Collaboration with the Westat, Inc., *The National Elder Abuse Incidence Study* (1998) 1, available at [http://www.aoa.gov/AoARoot/AoA\\_Programs/Elder\\_Rights/Elder\\_Abuse/docs/ABuseReport\\_Full.pdf](http://www.aoa.gov/AoARoot/AoA_Programs/Elder_Rights/Elder_Abuse/docs/ABuseReport_Full.pdf).

<sup>9</sup> IRS Publication 3865, *Your Money Matters, Tax Information for Survivors of Domestic Abuse* (Rev. Oct. 2009) informs taxpayers "Domestic abuse is not just physical abuse. It often includes economic control. As a survivor of domestic abuse, you can take control of your finances. An important part of managing your finances is understanding your tax rights and responsibilities."

**Domestic Violence and Abuse Have Consequences for Tax Administration.**

Many taxpayers who are victims of domestic violence or abuse interact with the IRS, sometimes in the context of enforcement or collection activities. They may not effectively disclose that they are victims, and if the IRS does not recognize that possibility, it may not elicit information that would achieve the correct tax result.

**Example:** The IRS disallows the dependency exemption, child tax credit, and Earned Income Tax Credit (EITC) that a taxpayer properly claimed on a return she filed using head of household filing status. The reason for the disallowance is that the taxpayer's ex-husband (who filed first and is not being audited) improperly claimed the same items with respect to their son on his separate return for the same tax year.<sup>10</sup> The taxpayer was abused by her ex-husband. Her overriding concern is to avoid contact with him. This means she may not reply to the IRS's automatically-generated notices about the discrepancy, preferring to forego tax benefits rather than risk contact with her former spouse. The IRS will make no other attempt to contact the taxpayer and if she does not respond to the notices, will assess additional tax against her by default. The abuser will have successfully "stolen" her tax benefits. Alternatively, if the taxpayer calls the IRS to discuss her tax liability, the IRS employee may notice that she is reluctant to explain her living arrangements and is unfamiliar with her previous tax filing history as a married taxpayer. The employee may perceive her as evasive and seeming to have "something to hide," suggesting that she cheated on her taxes. To the taxpayer, the tax benefits may not compensate for the shame she feels in discussing her abuse and the risk of IRS disclosure to her ex-husband. If the IRS employee does not tactfully explore the taxpayer's situation, elicit additional information, and assure the taxpayer that her information will be kept confidential, the IRS may assess additional tax against her, even though she, rather than her ex-husband, is entitled to the claimed exemption and credits.

Training about how to listen carefully and how to use specific communication approaches if there are signs of domestic violence would prevent communications with taxpayers from becoming barriers to relief. An employee who is able to reassure the victim and explore how to get good information is positioned to address the taxpayer's problem and arrive at the correct tax result.

Perhaps the most common situation in which the problem of abuse comes to IRS attention is when taxpayers request innocent spouse relief. The need for innocent spouse relief stems from the operation of IRC § 6013(d)(3), which imposes joint and several liability on

<sup>10</sup> There were 935,772 dependents claimed by more than one taxpayer for tax year 2010. Individual Returns Transaction File (IRTF) from the Compliance Data Warehouse (CDW) tax year 2010 through cycle 201130 (Sept. 2011). Taxpayers who are not married, and same-sex couples (whether married or not) may encounter the same issues with respect to the dependency exemption and related tax benefits as do married heterosexual couples. See Internal Revenue Code (IRC) § 151 (allowing deductions for personal exemptions); IRC § 152(a)(1); (f)(1)(B) (defining "child" to include an adopted child).

married taxpayers who file joint returns.<sup>11</sup> Joint and several liability means that the IRS may potentially collect the entire tax from a joint filer who is a victim of domestic abuse even if:

- None of the tax liability is attributable to the victim's earnings or deductions;
- The abusive spouse prepared the erroneous or fraudulent return;
- The joint filers are no longer married when the IRS seeks to collect; and
- Responsibility for the tax was assigned to the abusive spouse as part of a divorce decree.

If it were not for the availability of innocent spouse relief, victims of domestic violence and abuse would simply be at the mercy of their abusers with respect to a tax return they may have been powerless to review or correct.<sup>12</sup> Taxpayers who request innocent spouse relief complete an IRS form that includes a question about domestic violence and abuse; about 16 percent indicate that they are victims.<sup>13</sup> Other than through answers on the form, information about domestic violence and abuse may come to light during administrative consideration of a claim or when litigation ensues.<sup>14</sup>

### **The IRS Explicitly Takes Domestic Violence and Abuse into Account in Some Situations.**

The IRS takes abuse into account when it evaluates a claim for innocent spouse relief.<sup>15</sup> IRS Chief Counsel attorneys follow special procedures in cases in which a claim of innocent spouse relief is available, or where one of the spouses may have signed the return under duress. These procedures apply not only when a taxpayer asks for innocent spouse relief or alleges duress, but any time the field attorney or paralegal knows of facts that indicate these claims might be well-founded.<sup>16</sup> In 2011, IRS Small Business/Self-Employed (SB/SE) Counsel developed a "best practices" reference for SB/SE trial attorneys when handling innocent spouse cases. In abuse cases, best practices include requesting third-party information from persons who would have knowledge of whether abuse occurred;

<sup>11</sup> Married taxpayers in community property states who do not file joint returns are generally liable for the tax on half of community income, regardless of which spouse generated the income. *Poe v. Seaborn*, 282 U.S. 101 (1930).

<sup>12</sup> IRC §§ 6015 and 66(c), known as the innocent spouse provisions, permit relief from liability arising from a joint return or from the operation of community property law under certain circumstances. For a more detailed discussion of innocent spouse relief, see 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*, *infra*.

<sup>13</sup> Taxpayers request innocent spouse relief by submitting IRS Form 8857, *Request for Innocent Spouse Relief*. In a random sample of 290 Forms 8857 submitted during fiscal year (FY) 2011 that the IRS provided to TAS (IRS response to TAS information request (June 14, 2011)), TAS found that 45 taxpayers affirmatively answered the question "Were you a victim of spousal abuse or domestic violence during any of the tax years you want relief?"

<sup>14</sup> IRS response to TAS information request (Sept. 1, 2011).

<sup>15</sup> See, e.g., Rev. Proc. 2003-61, 2003-2 C.B. 296, used to evaluate claims under IRC § 6015(f). The presence of abuse may result in relief from tax attributable to the abused spouse's own items (sec. 4.01(7)(d)), may mitigate a spouse's knowledge of an item giving rise to a deficiency, and is a separate factor that weighs in favor of granting equitable relief (sec. 4.03(2)(b)(i)).

<sup>16</sup> Chief Counsel Directives Manual 35.4.1.8.1.2 (Aug. 11, 2004). Among other things, the procedures require that a reviewer of grade GS-15 or higher consider the case, and if the innocent spouse or duress claim is not conceded or settled, the reviewer must place a memorandum in the file explaining why the case should go to trial. A grade 15 manager (or other specially assigned reviewer in an "S" case) must also attend the trial, and following conclusion of the trial must again evaluate whether relief is warranted, documenting his or her conclusion in the file.

discussing the abuse allegations with the other spouse; if necessary, subpoenaing the other spouse to testify at trial; and determining which spouse is more credible as to whether there was abuse.<sup>17</sup> The National Taxpayer Advocate acknowledges the importance of fact-finding, especially where joint filers may have conflicting accounts. However, she is concerned that these practices might actually do harm, because they do not explain how to address victims' concerns that stem from abuse, as discussed below. For example, a victim of domestic violence or abuse might be so fearful of a former spouse that she or he would simply opt to not appear in court rather than risk any contact between them as they enter or leave the courtroom. Her or his truthful account may never be heard. An attorney who is alert to this possibility would be better able to manage and address such fearfulness.

The IRS's Criminal Investigation division handles informants who require anonymity because they are victims of domestic violence or abuse as confidential informants, and may offer them various levels of witness protection.<sup>18</sup>

In 2001, the IRS created training on domestic violence and abuse that is still used to train employees who evaluate innocent spouse claims.<sup>19</sup> However, the only IRS employees who routinely receive that training are the Wage and Investment division (W&I) employees working in the Centralized Innocent Spouse Unit.<sup>20</sup>

### **IRS Document-Oriented Systems and Expectations can be Obstacles to Relief for Victims of Domestic Violence and Abuse.**

Victims of domestic violence and abuse may not be able to substantiate the violence or abuse, which can create difficulties when they interact with a document-oriented IRS. There are many reasons why documentation may not be available, but an essential component of domestic violence is isolation imposed by the abuser, which leaves the victim with no access to social services or other witnesses who could corroborate or document the abuse. Isolation may also be self-imposed because the victim is ashamed of her or his condition, or the abuser may have convinced the victim that no one will believe her or him. The secrecy may be so complete that no one other than the victim (and the abuser) has clear knowledge of the violence. Family and friends may deny or have been shielded from

<sup>17</sup> IRS response to TAS information request (Sept. 1, 2011). The other best practices in abuse cases are: "Do not let trial be the first time that you hear the details of petitioner's allegations of abuse; Use informal and, if necessary, formal discovery to commit petitioner to his/her story well in advance of trial; Request documentation from petitioner to substantiate the abuse claim (restraining orders, police reports, doctor's notes, etc.); Recognize that abuse can play a part in all factors for purposes of ascertaining hazards (e.g., may still be married because of fear of leaving, may have reason to know because of duty of inquiry but is fearful to ask, may have mental or health issues because of abuse); Be aware that the Court is generally sympathetic to petitioners who claim to be victims of abuse and have credible evidence to support their claim. If you do not have any evidence to rebut petitioner's abuse claim, then settling or conceding the case may be the best option."

<sup>18</sup> IRS response to TAS information request (Sept. 1, 2011); IRM 9.4.2.5.1.1 (Mar. 3, 2007). Moreover, IRS and Chief Counsel employees may disclose domestic violence and abuse to federal, state, or local law enforcement officials pursuant to the provisions of IRM 11.3.34 (May 6, 2009).

<sup>19</sup> The training was patterned in part on training developed by The Community Tax Law Project, a low income taxpayer clinic in Richmond, VA, *Life After Domestic Violence: Escaping the Tax Consequences* (June 13, 2000). The training has been classified as obsolete as of Nov. 2004 and has not been updated. See IRS Catalog Information, available at <http://publish.no.irs.gov/cat12.cgi?request=CAT1&catnum=86924>.

<sup>20</sup> The IRS in 1998 created a specialized unit, the Centralized Cincinnati Innocent Spouse Operations Unit (CCISO), to handle innocent spouse claims under newly-enacted IRC § 6015.

knowledge of the abuse, bruises may have been hidden by clothing or makeup, and employment absences may have been masked by sick leave or changing jobs.<sup>21</sup> Most victims of domestic abuse do not seek medical attention.<sup>22</sup> Ultimately, the only available evidence of the abuse may be the victim's own testimony or affidavit.

Sometimes available documentation may actually undermine a victim's truthful claim of domestic violence or abuse. For example, a victim may seek a court protective order, only to later withdraw it or not resist an abuser's efforts to dismiss or quash it. This apparently inconsistent behavior may cast doubt on the victim's credibility. In reality, the inconsistency may simply reflect the changing dynamic of domestic abuse, best described as a cycle of violence.<sup>23</sup> An observer who is not familiar with domestic violence and abuse dynamics might question the victim's credibility because of contradictory behavior.

### **Failing to Recognize Domestic Violence and Abuse Can Lead to Incorrect Tax Results.**

When the IRS does not recognize and address domestic violence and abuse, it not only contributes to the taxpayer's distress, but also may arrive at the wrong tax result. Two recent cases illustrate the harm this can cause. In the recent *Stephenson* case, in which the Tax Court granted equitable innocent spouse relief, the taxpayer had difficulty convincing the IRS that she was a victim of physical violence as well as economic abuse.<sup>24</sup> Mrs. Stephenson had learning disabilities and consequently did not finish high school, nor was she able to pass the GED the three times she attempted it. Her husband, a licensed stockbroker who had served in the Marines, was physically abusive. Moreover, he did not allow Mrs. Stephenson access to the mailbox, and kept a filing cabinet with their financial documents under lock and key. When Mr. Stephenson needed Mrs. Stephenson to sign something, he placed it in front of her and told her where to sign. If Mrs. Stephenson asked questions, Mr. Stephenson threatened her or told her she was not intelligent enough to understand. When Mrs. Stephenson told her husband she was leaving him, he pushed her against a wall, pointed a gun at her head, and told her that he would kill her or himself if she left him. Mrs. Stephenson, with the help of a friend and while Mr. Stephenson was out of town, later fled to her mother's home and ultimately obtained a divorce decree.<sup>25</sup>

The court found that Mrs. Stephenson credibly testified as to specific examples of abuse, and her witness credibly testified about her bruises and how she had confided that she was

<sup>21</sup> This discussion is based on *Proving Physical Abuse or Extreme Cruelty*, based on a memorandum by Prof. Deborah Weissman, Univ. N. Carolina-Chapel Hill School of Law, on file with TAS.

<sup>22</sup> Dept. of Justice, *Full Report of the Prevalence, Incidence, and Consequences of Violence Against Women, Findings from the National Violence Against Women Survey* (July 2000), Exhibit 33, available at <http://www.ncjrs.gov/pdffiles1/nij/183781.pdf>.

<sup>23</sup> During early phases in the cycle in which tension builds and culminates in an explosive event, the victim may seek help from law enforcement authorities. However, the violent episode may be followed by the abuser's regret or contrition, expressions of apology, reconciliation, and a "honeymoon" phase, before the cycle begins again. During these later phases, the victim may withdraw her complaint or change her position. Lenore Walker, *The Battered Woman*, 3rd ed. 91-95, Springer Publishing Co., LLC (1979).

<sup>24</sup> *Stephenson v. Comm'r*, T.C. Memo. 2011-16.

<sup>25</sup> *Id.*, slip op. 2-6.

in an abusive relationship. But for the IRS, the lack of documentation supported its position that Mrs. Stephenson was not credible.<sup>26</sup>

In the recent *Thomassen* case, the Tax Court found domestic abuse was a very important factor in granting innocent spouse relief.<sup>27</sup> Mrs. Thomassen, a homemaker and part-time professional cellist, had earned a college degree with a major in music in 1950. She married Dr. Thomassen, an orthopedic surgeon, in 1953, and the couple had ten children. Dr. Thomassen was subject to fits of rage and extremely controlling behavior. For example, he would require his eldest son to get up at four a.m. every day to perform various tasks such as car repair.<sup>28</sup> When Dr. Thomassen found any white bread or any product containing sugar in the household, he would throw it away. Dr. Thomassen controlled the family finances; his office nurse paid the main household bills. He gave Mrs. Thomassen money for miscellaneous household expenses, but these amounts were often insufficient. Rather than risk angering Dr. Thomassen, Mrs. Thomassen would borrow money from her mother or sell personal items to meet the shortfall. She also used her earnings for this purpose. The couple had separate bank accounts, and Mrs. Thomassen had no credit cards. Dr. Thomassen never told Mrs. Thomassen his bank account balance or net worth. Dr. Thomassen either prepared the couple's tax returns himself or engaged someone else to do so, and then presented them to Mrs. Thomassen for her signature. She did not review the returns before signing them.

The Thomassens' eldest daughter once invited college friends to come home with her for the weekend. The friends were so shocked after witnessing Dr. Thomassen's behavior for a few days that they urged the daughter to find another place for Mrs. Thomassen and the other children to live. One of the friends observed that since Mrs. Thomassen had been subjected to Dr. Thomassen's behavior for her entire adult life, she probably did not realize anything was wrong.<sup>29</sup>

Mrs. Thomassen was also victimized by the manner in which Dr. Thomassen handled the couple's tax reporting and payment obligations. Six joint returns Dr. Thomassen prepared were filed untimely, all but one showing zero gross income and no tax owed. These returns led to notices of deficiency to which Dr. Thomassen responded by filing Tax Court petitions. In Tax Court, Dr. Thomassen appeared *pro se* (*i.e.*, without representation) on behalf of himself and Mrs. Thomassen and advanced frivolous arguments that resulted in dismissal of the cases and the entry of judgments against the Thomassens for deficiencies, and for

<sup>26</sup> *Stephenson v. Comm'r*, T.C. Memo. 2011-16, slip op. 25.

<sup>27</sup> *Thomassen v. Comm'r*, T.C. Memo. 2011-88.

<sup>28</sup> Dr. Thomassen had instructed his children not to answer the telephone or the door to the family residence because he was avoiding process servers. One teenage daughter inadvertently answered the door, which allowed papers to be served. Faced with the prospect of her father's anger over this, she attempted suicide. *Thomassen v. Comm'r*, T.C. Memo. 2011-88, slip op. 6.

<sup>29</sup> *Id.*, slip op. 2-6.

additions to the tax.<sup>30</sup> Dr. Thomassen persisted with frivolous appellate litigation, including an unsuccessful bid for Supreme Court review. Finally, when Dr. Thomassen was deceased for two years, Mrs. Thomassen was ordered evicted from her residence so it could be sold in a public sale to pay the taxes. It was at that point that she requested, and ultimately obtained, innocent spouse relief.<sup>31</sup>

### **Another Federal Enforcement Agency Responds to Domestic Violence and Abuse Issues.**

The IRS could gain inspiration from the manner in which another federal agency, U.S. Immigration and Customs Enforcement (ICE), takes into account domestic violence or abuse. For example, although ICE is aware that state or local law enforcement may arrest and book multiple people at the scene of alleged domestic violence, including the victim, ICE reminds its employees that it is against ICE policy to initiate removal proceedings against an individual known to be a victim of domestic violence. Employees are to exercise discretion in making detention and enforcement decisions regarding these victims.<sup>32</sup> Moreover, as part of the Secure Communities initiative, ICE will provide training to local law enforcement about the legal protections and relief for victims of violence and how best to interact with victims of these crimes.<sup>33</sup>

### **The IRS Does Not Provide Enough Information for Employees, Taxpayers, and Other Government Agencies.**

IRS employees may also be victims of domestic violence and abuse. The IRS offers them assistance, including access to professional counselors, through its Employee Assistance Program. However, there is no single source for information about nonprofit support organizations or the array of tax issues a victim of abuse is likely to encounter, such as identity theft, innocent spouse relief, injured spouse relief, determining proper filing status, claiming dependency exemptions, and claiming earned income and other tax credits.<sup>34</sup> Nor is any such resource available to the public. Consequently, employees and taxpayers alike are

<sup>30</sup> In Tax Court, Dr. Thomassen refused to provide substantiation of claimed expenses for his medical practice and other business activities because he contended that providing financial records and information to the government violated his constitutional rights and religious beliefs. *Thomassen v. Comm'r*, T.C. Memo. 2011-88, slip op. 9-10.

<sup>31</sup> *Id.*, slip. op. 7-14.

<sup>32</sup> Memorandum from John Morton, Director, U.S. immigration and Customs Enforcement, Prosecutorial Discretion: Certain Victims, Witnesses, and Plaintiffs (June 17, 2011), available at <http://www.ice.gov/doclib/secure-communities/pdf/domestic-violence.pdf>. In addition, according to the memorandum, an ICE database now flags victims of domestic violence who have filed for or been granted victim-based immigration relief in order for employees to respond appropriately. The IRS could explore the appropriateness of placing a domestic violence “marker” on the accounts of taxpayers who request such a marker, similar to the marker for accounts of victims of identity theft, in order for IRS employees to be aware of the problem whenever they interact with taxpayers.

<sup>33</sup> The Secure Communities program allows the FBI to automatically send fingerprints it receives from local law enforcement to ICE to check against its immigration databases. If these checks reveal that an individual is unlawfully present in the United States or otherwise removable due to a criminal conviction, ICE takes enforcement action. The program is described in the ICE website, at [http://www.ice.gov/secure\\_communities/](http://www.ice.gov/secure_communities/). See “DHS Plan to Provide Training to State and Local Law Enforcement in the Secure Communities Program,” available at <http://www.ilw.com/immigrationdaily/news/2011,0620-securecommunities.pdf>.

<sup>34</sup> IRS employees who take TAS training on domestic violence and abuse will have additional resources, including links to nonprofit support groups. Injured spouse relief may be appropriate where a spouse’s refund was, or will be, offset against the other joint filer’s separate past-due federal tax, state tax, child support, or federal non-tax debt (such as a student loan).

forced to piece together information from various IRS sources as they attempt to solve tax problems that stem from the abuse they experienced. Moreover, employees cannot refer taxpayers to a central source of information or to other nonprofit support organizations, and other federal agencies cannot direct taxpayers who are victims of domestic violence or abuse to an IRS website that meets their needs. The IRS could investigate opportunities to partner with other agencies that assist victims of domestic violence or abuse, such as by appearing in a directory similar to the Online Directory of Crime Victim Services sponsored by the Office for Victims of Crime (OVC).<sup>35</sup> The OVC directory is designed to help service providers and individuals locate nonemergency crime victim service agencies in the United States and abroad. It allows victims to search by location, type of victimization, service needed, and agency type.

#### **TAS Is Launching Initiatives to Heighten Awareness About Domestic Violence and Abuse.**

In October 2011, the National Taxpayer Advocate released training on domestic violence and abuse awareness that is required for all TAS employees, and is available to all IRS employees.<sup>36</sup> The training consists of a video that explores this issue with a panel of participants, including the National Taxpayer Advocate, the Executive Director of the District of Columbia Coalition Against Domestic Violence, a Low Income Taxpayer Clinic attorney, a Local Taxpayer Advocate, and a TAS attorney advisor. The video demonstrates through role-playing scenarios how IRS employees can identify taxpayers of domestic violence and abuse and interact with them appropriately. Written training materials, which contain links to other sources and nonprofit support organizations, supplement the video. TAS is including links to domestic violence resources in its tax toolkit, a public website that TAS maintains to provide taxpayer education. In addition to employee training, TAS is developing a brochure on the tax issues arising from domestic violence and abuse as part of its Consumer Tax Tips series.

### **CONCLUSION**

In conclusion, the National Taxpayer Advocate preliminarily recommends that:

1. The IRS should update its training for public contact and enforcement employees to focus on communication and interview skills, and should incorporate the training prepared by the Taxpayer Advocate Service, *Recognizing and Working with Taxpayers Who Have Experienced Domestic Violence or Abuse*;

<sup>35</sup> The Office for Victims of Crime is one of seven components within the Office of Justice Programs (OJP), U.S. Dept. of Justice. The OJP works in partnership with the justice community to identify the most pressing crime-related challenges confronting the justice system and to provide information, training, coordination, and innovative strategies and approaches for addressing these challenges. See Office of Justice Programs, About Us, available at <http://www.ojp.usdoj.gov/about/about.htm> (last visited Oct. 11, 2011). The Online Directory of Crime Victim Services is available at <http://ovc.ncjrs.gov/findvictimservices/search.asp> (last visited Oct. 11, 2011).

<sup>36</sup> *Recognizing and Working with Taxpayers Who Have Experienced Domestic Violence or Abuse*, IRS Enterprise Learning Management System (ELMS) course 41304.

2. The IRS should develop an online resource page on the internal website with information and resources for IRS employees who may be experiencing domestic violence and abuse;
3. The IRS should work with TAS to create a centralized electronic portal with information about domestic violence and abuse which would include guidance for IRS employees on assisting victims of domestic abuse;
4. The IRS, in collaboration with TAS, should develop a comprehensive communication strategy for taxpayers and other government agencies, with information about domestic violence and abuse and how to resolve tax issues that arise from it, and links to nonprofit support organizations. The strategy should also include distributing TAS's Consumer Tax Tips brochures on domestic violence and abuse and other related material.

### IRS COMMENTS

The IRS takes seriously the effects that domestic violence and abuse may have on taxpayers as well as on employees of the IRS. We recognize that abusive situations could result in tax consequences to the taxpayer that he or she is sometimes powerless to prevent.

The IRS is sensitive to the issues that may arise when dealing with victims of domestic abuse as well as other situations where a taxpayer may be an injured party. We strive to ensure our contact employees communicate with all taxpayers in a courteous and professional manner, with deference to their individual situations, through training and guidance such as IRM 21.1.1.7, *Accounts Management and Compliance Services Operations - Accounts Management & Compliance Services Overview - Communications Skills*: ELMS Lesson 43113, *Identity Theft Awareness Briefing*; and Interviewing Skills training. If a taxpayer makes our employees aware of her or his personal circumstances, employees are trained to provide the taxpayer with the appropriate guidance.

The IRS recently revised the rules that apply in innocent spouse determinations to expand the effect abuse will have in determining whether relief is warranted. The IRS recognizes that when abuse is present, the requesting spouse may not have been able to challenge the treatment of items on a tax return, question the payment of taxes, or challenge the other spouse's assurance regarding the payment of taxes. The new rules recognize that the presence of abuse may mitigate other factors that might otherwise weigh against granting relief. In connection with these changes, the IRS has recently increased its training to innocent spouse unit employees on domestic violence.

IRS employees have been trained to assist taxpayers and address questionable issues that may exist. If the taxpayer fails to bring the issues of domestic violence or abuse to the attention of IRS, an employee would follow the applicable procedures to address the issue based on the tax information that was submitted. IRS contact employees are not trained,

nor is it appropriate, to probe for these underlying issues or make assumptions about what underlying issues the taxpayer might be encountering.

The IRS ensures resources are provided to assist employees in dealing with a variety of personal issues including domestic violence. All IRS employees have access to the Employee Assistance Program (EAP). The EAP is a free benefit program that provides confidential counseling services to managers, employees, and their family members. EAP gives the employee access to a nationwide counseling network to help deal with personal and/or work-related problems. EAP counselors are licensed professionals that provide assistance in areas of relationship and domestic issues including domestic abuse.

With respect to the recommendations made in the report, the IRS notes the following.

The IRS continually updates training for public contact and enforcement employees and we will continue to focus on communication and interview skills. We are exploring opportunities at strengthening the Innocent Spouse program and updated the Innocent Spouse training (September 2011) to educate the examiners reviewing innocent spouse cases on communication and interview skills when contacting a spouse alleging abuse. This lesson was prepared with the assistance of a TAS Attorney Advisor and attorneys with the Low Income Taxpayer Clinics.

While we do not believe that it is appropriate to use the TAS course for all our employees, we will consider including key elements of the TAS training in future training curriculum updates and/or awareness sessions. Decisions on the method or form of any training would be based on the specific job duties of the employee.

With respect to the online resource page, the IRS already has available online resources to assist employees in dealing with a variety of personal issues including domestic violence. All IRS employees have access to the EAP. The EAP is a free benefit program that provides no-cost, confidential services to managers, employees, and their family members. EAP gives the employee access to a nationwide counseling network to help deal with personal and/or work-related problems. EAP counselors are licensed professionals. A prominent link to EAP information is included on the IRWeb home page.

With respect to the proposed electronic portal, we believe that the role of the IRS should be limited to assistance relating to federal tax matters. The IRS recognizes the importance of assisting victims of domestic violence with their federal tax matters, but additional full-service assistance on matters unrelated to taxes is more appropriately delivered outside of the agency.

The IRS continually evaluates whether additional outreach materials are necessary. It is possible that the information proposed to be developed could include tax-related issues and contact information for resolution of tax-related issues specific to taxpayers affected by domestic violence. However, it is unclear whether IRS.gov is an appropriate point for

a centralized clearinghouse on domestic violence and abuse. Nevertheless, the web page could provide a link for interested taxpayers to request the proposed TAS developed brochure on domestic violence and abuse.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate welcomes the IRS's acknowledgement that domestic violence and abuse produce real tax consequences, and its confirmation that IRS employees are trained on the substance of the tax laws and on how to be courteous to taxpayers. We believe many if not most employees respond appropriately when a taxpayer demonstrates, in a manner familiar to the employee, that the taxpayer is a victim of domestic violence or abuse.

However, the National Taxpayer Advocate is disappointed by the IRS's formulaic response to several of our preliminary recommendations, which appears to belie its commitment to this issue. The unaddressed problem is that unless taxpayers explicitly allege abuse, employees are not trained to recognize that it may be an issue.<sup>37</sup> The training TAS prepared and recommends is not designed to make IRS employees into professional counselors, but rather to raise awareness and suggest ways of eliciting information that would tend to show whether abuse is present and is relevant to the tax matter at hand.<sup>38</sup>

Employees are not currently trained to begin their analysis by believing a taxpayer who indicates that he or she is a victim of abuse and then considering what, if any, evidence is available to support the claim. On the contrary, the IRS's position is that such training would not be "appropriate" because it would require employees to "probe" and "make assumptions." The National Taxpayer Advocate believes the IRS can and should do more to train employees to listen actively and sensitively, especially in the domestic violence area. By listening to taxpayers in this way, IRS employees will be able to secure information that will produce the correct tax result. She finds it rather astonishing that the IRS views such training as not appropriate for its public contact employees, and will work toward including portions, if not all, of the Taxpayer Advocate Service's domestic violence training into the IRS's future training.

<sup>37</sup> A recently released report from the Centers for Disease Control found that one in four women in the United States have been victims of *severe physical violence* by an intimate partner while one in seven men experienced severe violence by an intimate partner. Centers for Disease Control and Prevention, *The National Intimate Partner and Sexual Violence Survey (NISVS)* (Nov. 2011) 43, available at [http://www.cdc.gov/ViolencePrevention/pdf/NISVS\\_Report2010-a.pdf](http://www.cdc.gov/ViolencePrevention/pdf/NISVS_Report2010-a.pdf). The survey found that 24.3 percent of women and 13.8 percent of men had experienced *severe physical violence* by an intimate partner. Severe physical violence includes being hurt by pulling hair, being hit with something hard, being kicked, being slammed against something, attempts to hurt by choking or suffocating, being beaten, being burned on purpose, and having a partner use a knife or gun against the victim. (NISVS at 10.) The continued prevalence of domestic violence and abuse makes it all the more urgent that the IRS train its employees to recognize and address the impact of domestic violence on tax administration.

<sup>38</sup> TAS has also developed a 15-minute version of the training and is developing a 45-60 minute version that would be suitable for front-line employees who do not handle technical matters, but who refer taxpayers to other IRS offices or divisions.

The National Taxpayer Advocate is perplexed by the IRS's reluctance to provide more comprehensive information for its employees on an internal website. The EAP is an important resource, but employees who are victims of abuse need one central web page with information about the *tax* issues they may consequently encounter. The IRS is better positioned than any other employer to provide this resource.

We are pleased that the IRS agrees to work with TAS to create an electronic portal to enable employees to assist victims of domestic violence and abuse, even with the proviso that "additional full service assistance on matters unrelated to taxes is more appropriately delivered outside of the agency." TAS agrees with this proviso. We do not propose that the IRS itself should supply counseling, medical, or other non-tax assistance, but rather that it provide links to nonprofit service providers, support organizations, and emergency hotlines for employees to share with taxpayers. The IRS does not reject our recommendation that it collaborate with us in developing a comprehensive communications strategy, and we hope that we will be able to work together on this project.

## Recommendations

The National Taxpayer Advocate recommends that the IRS:

1. 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, *Recognizing and Working with Taxpayers Who Have Experienced Domestic Violence or Abuse*.
2. 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.
3. Develop a resource page on the internal website with information and resources for IRS employees who may be experiencing domestic violence and abuse.
4. In collaboration with TAS, develop a comprehensive communication strategy for taxpayers and other government agencies, with information about domestic violence and abuse and how to resolve related tax issues. The strategy should include links to nonprofit support organizations and would involve distributing TAS's Consumer Tax Tips brochures on domestic violence and abuse and other related material.

## MSP #17

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

### RESPONSIBLE OFFICIALS

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

### DEFINITION OF PROBLEM

The IRS is responsible for collecting billions of dollars from millions of taxpayers who have delinquent tax accounts.<sup>1</sup> However, it does not attempt personal contact with these taxpayers (*i.e.*, by telephone or face-to-face) to find out why they are not paying and discuss collection alternatives until late in the collection process. While the current collection system has achieved moderate success (collecting \$64 out of every \$100 owed) by sending notices in the early stages of delinquency, this method is not effective for all taxpayers, particularly those with large debts or complex problems.<sup>2</sup>

The IRS annually sends over 34 million notices to taxpayers in the first stage of the collection process.<sup>3</sup> However, the average payment received from an individual taxpayer in response to a notice in fiscal year (FY) 2011 was just \$517 (which reflects mostly low-dollar cases).<sup>4</sup> In FY 2011, 3.7 million cases remained unresolved after this initial stage<sup>5</sup> and moved to the Automated Collection System (ACS), where the IRS traditionally spends only about three percent of its direct time making outgoing calls.<sup>6</sup> According to recent data, 60 percent of the cases in ACS have been there six months or longer.<sup>7</sup>

Cases unresolved after being processed by the ACS move into a queue where they remain until a field revenue officer is available to work them.<sup>8</sup> The dollar value of cases assigned to the queue has doubled in the last six years — to over \$56.2 billion at the end of FY 2011.<sup>9</sup> Making personal contact before sending the case to the queue could provide an opportunity

<sup>1</sup> At the beginning of fiscal year (FY) 2010, 4,031,093 taxpayers had delinquent accounts. Small Business/Self-Employed (SB/SE) division, Collection Activity Report NO-5000-2.

<sup>2</sup> IRS, Collection Activity Report NO-5000-242, *Taxpayer Delinquent Account Cumulative Report, Part 2 – Accounts Receivable Notices* (Oct. 2011).

<sup>3</sup> *Id.*

<sup>4</sup> IRS, Collection Activity Report NO-5000-8, *IMF Collection Yield Report FY 2011*. The IRS received approximately \$9.9 billion from individual taxpayers (IMF) through 19,185,673 payment transactions.

<sup>5</sup> During FY 2011, the IRS collected nearly \$9.5 billion on nearly 2.7 million taxpayer accounts during the notice stream, but the Automated Collection System (ACS) received 3,706,183 taxpayer cases. IRS, Collection Activity Report NO-5000-242, *Taxpayer Delinquent Account Cumulative Report, Part 2 – Accounts Receivable Notices* (Oct. 2011); IRS, Collection Activity Report NO-5000-2, *Taxpayer Delinquent Account Reports* (Oct. 2011).

<sup>6</sup> Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2010-30-046, *More Management Information is Needed to Improve Oversight of Automated Collection System Outbound Calls* 6 (Apr. 28, 2010).

<sup>7</sup> At the conclusion of FY 2011, 2,454,770 ACS modules were in ACS less than six months, out of a total inventory of 6,080,835. Collection Activity Report NO-5000-2 (Oct. 2011).

<sup>8</sup> Internal Revenue Manual (IRM) Exhibit 5.19.5-9 (Dec. 1, 2007).

<sup>9</sup> IRS, Collection Activity Report NO-5000-2, *Taxpayer Delinquent Account Reports* (Oct. 2011).

for the IRS to answer questions, discuss payment alternatives, and advise the taxpayer of potential enforcement if deadlines are missed. This approach is critical because different explanations for noncompliance require different approaches to case resolution.

The current approach of exhausting automated efforts before making human contact overlooks the fact that debt problems tend to worsen over time. 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.<sup>10</sup> To make matters worse, businesses can accrue an average of two years of tax debt before the IRS even tries to make personal contact.<sup>11</sup>

Since 2004, the National Taxpayer Advocate has urged the IRS to adopt collection policies that emphasize personal contact, both by telephone and face-to-face.<sup>12</sup> Doing so might allow the IRS to resolve cases more quickly, a change sorely needed during a period in which the inventory of unpaid assessments has grown by 33 percent in the past five years.<sup>13</sup> In fact, an IRS pilot program that incorporates personal taxpayer contacts has resolved 40 percent more cases within six months than cases handled under the IRS's standard procedures.<sup>14</sup>

## ANALYSIS OF PROBLEM

### Background

#### *The Collection Process Begins with the "Notice Stream."*

When an assessment is made but no payment is forthcoming, the IRS begins a three-stage collection process.<sup>15</sup> In the first stage, known as the notice stream, the IRS sends the taxpayer a series of notices, beginning with a Notice and Demand for Payment.<sup>16</sup> If this notice

<sup>10</sup> BANXQUOTE Rx, Business Debt Restructuring Solutions, [www.banx.com/rx/](http://www.banx.com/rx/).

<sup>11</sup> *Hearing on How Tax Complexity Hinders Small Businesses: The Impact on Job Creation and Economic Growth Before the Committee on Small Business*, 112th Cong. 21 (Apr. 13, 2011) (statement of Nina E. Olson, National Taxpayer Advocate).

<sup>12</sup> See National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 40-70 (TAS Research Study: An Analysis of the IRS Collection Strategy: *Suggestions to Increase Revenue, Improve Taxpayer Service, and Further the IRS Mission*); National Taxpayer Advocate 2006 Annual Report to Congress 62-82 (Most Serious Problem: *Early Intervention in IRS Collection Cases*), 83-109 (Most Serious Problem: *IRS Collection Payment Alternatives*), 110-129 (Most Serious Problem: *Levies*), 141-156 (Most Serious Problem: *Collection Issues of Low Income Taxpayers*); National Taxpayer Advocate 2009 Annual Report to Congress 17-40 (*One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of the Law, Fail to Promote Future Tax Compliance and Unnecessarily Harm Taxpayers*); National Taxpayer Advocate 2008 Annual Report to Congress 114-125 (*Navigating the IRS*); National Taxpayer Advocate 2004 Annual Report to Congress 226-245 (*IRS Collection Strategy*).

<sup>13</sup> IRS, *Collection Process Study, Executive Summary 2* (Sept. 30, 2010). The data for the balance of unpaid assessments at the conclusions of FY 2010 was provided by SB/SE in an email message dated Dec. 14, 2010.

<sup>14</sup> Response to TAS information request (Sept. 28, 2011). The IRS is currently testing a streamlined offer in compromise (OIC) program that requires "out-bound" calls to taxpayers. Under the standard program, 48.07 percent of cases are resolved within six months. Under the streamlined program, 68.46 percent are resolved within six months, even though that figure includes cases that were already aged before being brought into the program.

<sup>15</sup> The IRS collection process begins with an assessment, which can occur through three different methods:

- Self-assessment by the taxpayer when a return is filed;
- IRS assessment based on deficiency procedures and after the taxpayer has exhausted (or failed to exercise) all appeal rights; or
- IRS-prepared "substitute for return" (SFR) where the taxpayer has failed to file a timely tax return (See Internal Revenue Code (IRC) § 6020(b)).

<sup>16</sup> IRC § 6303(a); IRM Exhibit 5.19.1-2 (Apr. 28, 2008). The IRS also refers to the Notice and Demand for Payment as the "first notice."

does not result in a payment or other resolution of the debt, the taxpayer may receive one to three additional notices, depending on the characteristics of the case.<sup>17</sup> During this time, the IRS does little to actively reach out to taxpayers and attempt to resolve their debt problems.<sup>18</sup>

In FY 2010, the IRS collected approximately \$28.4 billion through the notice stream, representing approximately 64 percent of the total yield on these collection accounts.<sup>19</sup> However, a closer analysis indicates notices may be most effective with taxpayers who owe relatively little, as the average payment received from individual taxpayers in response to a notice in FY 2011 was \$517.<sup>20</sup> Taxpayers who face more significant tax obligations may not be able to pay in full at this stage and may require a conversation to determine the appropriate collection alternative.

*The Automated Collection System is the Second Stage of the Process.*

For most taxpayers, the second stage of the collection process involves the ACS.<sup>21</sup> In FY 2011, nearly 3.7 million cases went to the ACS for processing.<sup>22</sup> Although the ACS was originally designed as an *outgoing* call program to contact taxpayers with delinquent accounts, it has devolved into what its name implies: an automated, impersonal process, relying on systemically-generated enforcement actions. Instead of reaching out to taxpayers, the ACS interacts with them mainly through incoming calls that are generally in response to the levies and liens it generates. As of September 2011, the dollar value of cases assigned to ACS was \$30.9 billion,<sup>23</sup> yet it spends less than three percent of its direct time making outgoing calls using a predictive dialer system.<sup>24</sup> The IRS fails to use a multi-faceted collection strategy, even at this stage of the delinquency process.

<sup>17</sup> Most cases involving individual income taxes reported on Form 1040, *U.S. Individual Income Tax Return*, receive up to three additional collection notices. Delinquencies involving employment taxes reported on Form 941, *Employer's Quarterly Federal Tax Return*, usually receive one additional notice.

<sup>18</sup> See National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 40-70 (TAS Research Study: *An Analysis of the IRS Collection Strategy: Suggestions to Increase Revenue, Improve Taxpayer Service, and Further the IRS Mission*).

<sup>19</sup> IRS, *Delinquent Accounts Receivable Yield Report, Fiscal Year Comparison Cum Thru FY 2011 October*; IRS, Collection Activity Report, NO-5000-6, *Installment Agreement Cumulative Report* (Oct. 3, 2011); IRS, Collection Activity Report NO-5000-242, *Taxpayer Delinquent Account Cumulative Report, Part 2 – Accounts Receivable Notices* (Oct. 5 2011). In FY 2011, the IRS collected approximately \$16.8 billion on the initial collection notice, \$6.2 billion on the second thru final notices, and \$5.1 billion from installment agreements (IAs) issued by Accounts Management (AM) and Compliance Services Collection Operations (CSCO), totaling \$28.1 billion. Payments related to a notice account that were included in IAs established through the ACS or Collection Field Function (CF) operations were not included in the total.

<sup>20</sup> IRS, Collection Activity Report NO-5000-8, *IMF Collection Yield Report FY 2011*. The IRS received approximately \$9.9 billion from individual taxpayers (IMF) through 19,185,673 payment transactions.

<sup>21</sup> The ACS is a computerized inventory system and telephone call center that was designed to assign cases to contact representatives or tax examiners who interact with taxpayers about delinquent accounts. IRM 5.19.5.1 (Dec. 1, 2007).

<sup>22</sup> During FY 2011, ACS received 3,706,183 taxpayer cases. IRS, Collection Activity Report NO-5000-2, *Taxpayer Delinquent Account Reports* (Oct. 2011).

<sup>23</sup> IRS, Collection Activity Report 5000-2, *Taxpayer Delinquent Account Reports* (Oct. 2011).

<sup>24</sup> TIGTA, Ref. No. 2010-30-046, *More Management Information is Needed to Improve Oversight of Automated Collection System Outbound Calls* 6 (Apr. 28, 2010). IRM Exhibit 5.19.5-11 (Dec. 1, 2007). A predictive dialer system places calls without an attending agent on the originating line. If contact is made, the dialer transfers the call along with the ACS case to a waiting agent. Once the dialer makes two attempts to contact the taxpayer, the case is transferred to another ACS function for the next action, which could be a levy or lien.

***The Queue Receives Cases After the ACS Attempts to Resolve Them.***

While not technically a stage in the collection process, the queue is an electronic inventory file that holds balance due and delinquent return accounts until a field revenue officer is available to work the case.<sup>25</sup> The IRS generally moves taxpayer cases to the queue after the ACS makes some attempt to resolve the accounts (usually by lien or levy). Generally, the IRS takes no enforcement actions while cases reside in the queue (other than automated refund offsets), but the accounts continue to accrue penalties and interest. Moreover, the law only requires the IRS to send updated balance information about these accounts on an annual basis.<sup>26</sup> The dollar value of cases assigned to the queue has doubled in the last six years — to over \$56.2 billion at the end of FY 2011.<sup>27</sup>

***The Third Stage of the Process Involves the Collection Field Function.***

The Collection Field function (CFf) is the final stage of the collection process, and the first stage at which an IRS employee attempts to contact the taxpayer in person. Relatively few of the collection cases left unresolved by the notice stream and the ACS are actually assigned to the CFf.<sup>28</sup> Revenue officers (ROs) routinely work in the “field” contacting taxpayers by visiting their homes or places of business to discuss payment alternatives. If the taxpayer is not in when the RO visits, he or she will generally leave a “calling card”<sup>29</sup> with a deadline for the taxpayer to respond. If the taxpayer fails to call, the IRS response, especially in recent years, has been enforcement, with particular emphasis on levies, liens, and assessment of the Trust Fund Recovery Penalty (TFRP) for business accounts.<sup>30</sup>

**Business As Usual is No Longer Good Business**

Since 2004, the National Taxpayer Advocate has urged the IRS to reassess its collection strategy and has provided numerous recommendations to improve efficiency. In 2004, the National Taxpayer Advocate recommended a different collection philosophy that would recognize five important aspects of modern collection practices:

1. Prompt person-to-person contact with debtors;
2. Focus on the “why” of noncompliance;
3. An appropriate collection “touch” for the appropriate type of noncompliance;
4. A research-based approach to collection initiatives; and

<sup>25</sup> IRM Exhibit 5.19.5-9 (Dec. 1, 2007).

<sup>26</sup> IRC § 7524.

<sup>27</sup> IRS, Collection Activity Report NO-5000-2, *Taxpayer Delinquent Account Reports* (Oct. 2011). A Taxpayer Delinquent Account (TDA) represents a balance due account for a specific taxpayer, tax return, and period.

<sup>28</sup> See National Taxpayer Advocate 2004 Annual Report to Congress 226-245 (Most Serious Problem: *IRS Collection Strategy*).

<sup>29</sup> Revenue officers leave Form 2246, *Field Contact Card*, if contact with the taxpayer is not made during the first attempted field contact.

<sup>30</sup> See National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 40-70 (*TAS Research Study: An Analysis of the IRS Collection Strategy: Suggestions to Increase Revenue, Improve Taxpayer Service, and Further the IRS Mission*). The TFRP is a penalty provided by IRC § 6672 against any person required to collect, account for, and pay over taxes held in trust who willfully fails to perform any of these activities. IRM 5.7.3.1 (Nov. 12, 2010).

#### 5. Prevention of opportunities for noncompliance.<sup>31</sup>

In 2006, the National Taxpayer Advocate stressed the importance of personal taxpayer contacts in four Most Serious Problems (MSPs) discussing IRS collection practices and strategies.<sup>32</sup> This report included two especially important recommendations stating that the IRS should:<sup>33</sup>

- Place top priority on initiating personal contacts on current accounts (*i.e.*, delinquencies on recently due tax periods involving taxpayers who have not resolved their delinquencies through the collection notice process); and
- Find ways to expedite personal taxpayer contact on collection cases where it is evident such actions are needed for mutually successful resolutions.

The IRS has agreed that personal contact is an important tool for helping taxpayers return to compliance but indicated that its collection systems, including the notice process and other operations, are designed to direct as many taxpayers as possible to what it views as the least invasive and burdensome options.<sup>34</sup>

In 2008, the National Taxpayer Advocate offered five recommendations that would make it easier for the taxpayer to establish personal contact with a specific IRS employee.<sup>35</sup> To date, the IRS has rejected all five.<sup>36</sup>

Finally, in 2010, the National Taxpayer Advocate provided an in-depth analysis of the IRS collection strategy as well as several recommendations to increase revenue, improve taxpayer service, and further the IRS mission.<sup>37</sup> Unfortunately, in spite of these recommendations, the IRS has not fully adopted a more personal approach toward collection.

Many collection results have seen a marked decline over the past six fiscal years (2006–2011):

- The inventory of unpaid assessments has grown from approximately \$270 billion in FY 2006 to \$373 billion in FY 2011 — an increase of 38 percent.<sup>38</sup>

<sup>31</sup> See National Taxpayer Advocate 2004 Annual Report to Congress 226-245 (Most Serious Problem: *IRS Collection Strategy*).

<sup>32</sup> See National Taxpayer Advocate 2006 Annual Report to Congress 62-82 (Most Serious Problem: *Early Intervention in IRS Collection Cases*); 83-109 (Most Serious Problem: *IRS Collection Payment Alternatives*); 110-129 (Most Serious Problem: *Levies*); 141-156 (Most Serious Problem: *Collection Issues of Low Income Taxpayers*).

<sup>33</sup> *Id.* at 80 (Most Serious Problem: *Early Intervention in IRS Collection Cases*).

<sup>34</sup> See National Taxpayer Advocate 2006 Annual Report to Congress 76 (Most Serious Problem: *Early Intervention in IRS Collection Cases*).

<sup>35</sup> See National Taxpayer Advocate 2008 Annual Report to Congress 125 (Most Serious Problem: *Navigating the IRS*). The recommendations included: 1. Revise the IRM to direct employees to accommodate taxpayer requests to speak to a particular employee whenever feasible. 2. Create a personnel directory for internal use, searchable by the same employee number that IRS employees give to taxpayers. 3. Create a personnel directory for internal use organized by business function. 4. Adjust the topical tax index on IRS.gov to include telephone numbers of offices associated with each topic, and 5. Establish a cognitive learning lab to test and observe taxpayers' experiences in navigating the IRS.

<sup>36</sup> Joint Audit Management Enterprise System (JAMES), *IRS Response to 2008 Annual Report to Congress* (Nov. 4, 2009).

<sup>37</sup> See National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 40-70 (TAS Research Study: *An Analysis of the IRS Collection Strategy: Suggestions to Increase Revenue, Improve Taxpayer Service, and Further the IRS Mission*).

<sup>38</sup> IRS, Accounts Receivable on the Compliance Data Warehouse (CDW).

- Dollars reported as currently not collectible (CNC) rose from \$16.2 billion in FY 2006 to \$32.3 billion in FY 2011 — an increase of 99 percent.<sup>39</sup>
- The number of taxpayer accounts reported as CNC increased by 73 percent — from 751,012 in FY 2006 to nearly 1.3 million in FY 2011.<sup>40</sup>
- The amount of TDA dollars reported as “surveyed” by the IRS more than tripled during this period — from approximately \$2.7 billion to \$8.8 billion.<sup>41</sup>

These data clearly indicate that the current IRS collection strategy is not working, and it is time for a new approach. Recognizing that the IRS’s resources are limited, it can still apply those resources in a different way. Under the current system, a great deal of time passes and interest and penalties accrue before the IRS attempts to make a personal contact with most delinquent taxpayers. If the IRS reaches out to a taxpayer early in the collection process, it may be able to reach a solution to the tax debt, where contact later in the process usually brings fewer resolution options.

To help the growing number of struggling taxpayers, the IRS announced the new “Fresh Start” program in February 2011. As part of this initiative, the IRS has increased access to installment agreements (IAs) and streamlined offers in compromise and has changed some lien policies and procedures. Although this initiative could potentially provide relief to many delinquent taxpayers, communication with the taxpayer is the first step. The IRS also has increased the number of special open houses it holds at its field assistance centers but has failed to adopt a multi-faceted strategy to initiate personal contact. Taxpayers must know what collection alternatives they have available. If the IRS reached out to more taxpayers early in the collection process through personal contacts, it could resolve some of the rising number of delinquent accounts, and be able to focus more of its limited resources on the remaining accounts.

### Talking with Taxpayers is a Core IRS Responsibility.

Taxpayers have continually told the IRS, “We want to talk with you.”<sup>42</sup> In a 2006 IRS Oversight Board survey, *Taxpayer Customer Service and Channel Preference*, respondents consistently preferred phone or face-to-face contact to other types of assistance.<sup>43</sup> The IRS has a responsibility to talk with taxpayers to determine the reasons behind their tax liabilities. This approach is critical because different explanations for noncompliance require different approaches to case resolution. For example, a taxpayer who fell behind on tax payments because a heart condition kept him from working should be treated differently

<sup>39</sup> IRS, Collection Activity Report NO-5000-149, *Recap of Accounts Currently Not Collectible Report* (Oct. 2011).

<sup>40</sup> *Id.*

<sup>41</sup> See National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 48 (TAS Research Study: *An Analysis of the IRS Collection Strategy: Suggestions to Increase Revenue, Improve Taxpayer Service, and Further the IRS Mission*). Accounts reported as currently not collectible - “surveyed” represent situations where the IRS has chosen not to pursue collection, even though the collection statute remains open. Usually, these decisions are driven by the availability of IRS collection resources. IRS, Collection Activity Report NO-5000-2, *Taxpayer Delinquent Account Reports* (Oct. 2011).

<sup>42</sup> IRS Oversight Board, *Taxpayer Customer Service and Channel Preference* (Nov. 2006).

<sup>43</sup> *Id.*

from one deliberately trying to hide assets offshore or consistently underreporting income. The IRS must attempt to talk with the taxpayer to properly assess the reason for his or her unresponsiveness and determine what action is best.

The impact on taxpayers when the IRS sends notices instead of attempting to phone or visit can be significant. Not only can IRS notices be difficult to understand and misleading, but almost ten percent of them go undelivered, leaving taxpayers unaware that they may be facing liens or levies.<sup>44</sup> Making personal contact before sending the case to the queue could alleviate many of these issues. The IRS could answer questions, discuss payment alternatives, and advise of potential enforcement if deadlines are missed. Taxpayers may be misled by the lack of personal contact, especially when they are in the queue and receiving only an annual notice from the IRS, thinking that “no news is good news” and everything must be resolved or the IRS would call. Unfortunately, that is often not the case, as penalties and interest continue to accrue and the IRS may be moving forward with enforcement. The National Taxpayer Advocate has recommended abolishing the queue altogether. However, as long as the IRS considers it a necessity, it should do more than merely send out a notice. It should reach out personally to the taxpayers assigned to the queue, at least on an annual basis.

Personal contact becomes even more imperative for small business employers, which can accrue tax liabilities every quarter.<sup>45</sup> Looking at the life cycle of a tax liability on Form 941, *Employer’s Quarterly Federal Tax Return*, 47 percent of these liabilities are paid in response to the first notice. However, 55.3 percent of the 3.4 million returns assigned to the CFF (revenue officers) are paid in full when the ROs make personal contact.<sup>46</sup>

Although early intervention in collecting pyramiding Form 941 tax liabilities is critically important, businesses can accrue on average two years of tax debt before the IRS ever attempts personal contact.<sup>47</sup> Thirty-five percent of the payroll tax cases that entered the queue between FY 2004 and FY 2008 pyramided additional liabilities.<sup>48</sup> When the IRS has made no other attempt to notify or contact the taxpayer, 34 percent of the pyramiding accounts grew by three or more tax modules and 36 percent grew by amounts greater than \$10,000.<sup>49</sup>

<sup>44</sup> See National Taxpayer Advocate 2010 Annual Report to Congress 221-234 (Most Serious Problem: *The IRS Has Not Studied or Addressed the Impact of the Large Volume of Undelivered Mail on Taxpayers*).

<sup>45</sup> Employers file Form 941, *Employer’s Quarterly Federal Tax Return*, each quarter to report income and Social Security taxes withheld from the employees.

<sup>46</sup> IRS, *A Survival Analysis of IRS Collection Treatments for Unpaid Form 941 Employment Taxes* (June 2010).

<sup>47</sup> *Hearing on How Tax Complexity Hinders Small Businesses: The Impact on Job Creation and Economic Growth before the Committee on Small Business*, 112th Cong. 21 (Apr. 13, 2011) (statement of Nina E. Olson, National Taxpayer Advocate). Of the BMF Trust Fund notices that were not resolved in the notice stream during FY 2010, approximately 23 percent were “closed” as “deferred” accounts, i.e., due to the relatively small dollar amounts of the delinquencies, the IRS systemically determined not to pursue them as taxpayer delinquent accounts (TDAs). IRS, *Collection Activity Report NO-5000-242, TDA Cumulative Report, Part 2 – Accounts Receivable Notices* (Oct. 2010).

<sup>48</sup> SB/SE Research, “Happy Friday” (Oct. 29, 2010). In a study requested by SB/SE Collection Policy to support employment tax (ET) strategy, SB/SE Research provided information on pyramiding ET cases in the queue.

<sup>49</sup> *Id.*

Another situation where a personal conversation may yield positive results is when an individual or business taxpayer defaults on a payment plan. In FY 2011, the ACS received approximately 1.7 million tax modules with balances due that the taxpayers had originally agreed to pay through installment agreements, but which now the IRS considered in default — a default rate of 21 percent.<sup>50</sup> The IRS could resolve these accounts more efficiently with follow-up telephone contacts since it already has access to the taxpayers' information. Many of these taxpayers are attempting to pay what they owe but cannot adhere to the original terms due to unforeseen circumstances such as a job loss, medical emergency, or additional living expenses. In the 2010 Annual Report, the National Taxpayer Advocate recommended that the IRS revise its form letter for "streamlined" IAs to advise the taxpayer to contact the IRS if he or she cannot make the payments for any reason.<sup>51</sup> Still, few IRS collection procedures (outside of the Cff) require the IRS to proactively reach out and talk to taxpayers.

#### **Enforcement Should Not Be Used as a "Calling Card."**

Taxpayers who cannot pay their debts in full and do not contact the IRS because they do not know what to expect may be subject to increased burden or serious financial harm. The IRS has very powerful collection tools and can take actions such as levies and liens without first going to court to reduce the liabilities to judgments.<sup>52</sup> The IRS is not hesitant to use these tools, even during significant economic downturns. In FY 2011, the IRS filed over one million liens<sup>53</sup> and issued 3.7 million levies.<sup>54</sup>

However, the IRS incurs additional costs and work by enforcing first and asking questions later.<sup>55</sup> For example, the ACS might issue a Notice of Levy seizing all available funds in a taxpayer's bank account before anyone actually talks to the taxpayer. When the taxpayer learns he no longer has access to the money, he calls the ACS and explains why he does not owe the tax balance. The ACS researches the issue, determines the taxpayer is correct, releases the levy, and prepares paperwork to adjust the tax balance. If the ACS had phoned the taxpayer first, the levy and subsequent release might have been avoided, saving both the taxpayer and the IRS time and money.<sup>56</sup>

<sup>50</sup> IRS, Collection Activity Report NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Oct. 2011); IRS, Collection Activity Report NO-5000-6, *Installment Agreement Cumulative Report* (Oct. 2011).

<sup>51</sup> See National Taxpayer Advocate 2010 Annual Report to Congress 197 (Most Serious Problem: *IRS Collection Policies Channel Taxpayers Into Installment Agreements They Cannot Afford*).

<sup>52</sup> IRC § 6331.

<sup>53</sup> IRS, Collection Activity Report NO-5000-C23, *Collection Workload Indicators* (Oct. 2011).

<sup>54</sup> *Id.*

<sup>55</sup> IRS, Collection Activity Report 5000-2, *Taxpayer Delinquent Account Reports* (Oct. 2011). Of the 1.6 million ACS full pay dispositions in FY 2011, 34,042 cases were closed to adjustments.

<sup>56</sup> Even when the IRS releases a levy, the taxpayer may still incur bank fees (e.g., for overdraft protection or insufficient funds in an account).

IRS rework is also found in the Automated Substitute for Return (ASFR) program, where the IRS prepares a return for the taxpayer.<sup>57</sup> Because the IRS does not have access to all of the taxpayer's deductions or expenses, the taxpayer usually ends up owing more on the IRS-prepared return. Once the taxpayer files an original return, the IRS must adjust the tax balance, penalty, and interest to reflect the accurate original return.<sup>58</sup> Based on this approach, the IRS spends excess time processing accounts, when a simple phone call early in the delinquency could resolve the problem faster and more efficiently.

### IRS Has Achieved Success in Talking with Taxpayers.

The IRS has already experienced some success with personal taxpayer contact in its ACS hybrid project as well as the streamlined Centralized Offer in Compromise (COIC) pilot program, which was expanded twice in FY 2011.<sup>59</sup> The IRS should use this knowledge and information to test personal taxpayer contact in other areas – for example, during the first six months of the debt, before moving a case from ACS to the Collection queue and before the default of an IA.

## CONCLUSION

The National Taxpayer Advocate believes effective personal contact at the earliest possible time should be the key focus of IRS collection work. Enforcement tools such as the lien and levy should be reserved for situations where a taxpayer is unwilling to cooperate or comply.<sup>60</sup> The taxpayer's failure to respond to an IRS notice is not necessarily indicative of the taxpayer's unwillingness to cooperate or comply. However, the current IRS collection strategy treats delinquent taxpayers as if they have consciously decided not to comply, using the "full force of the law" in a manner that may be premature, unnecessary, and counterproductive. A more effective collection strategy must place greater emphasis on providing timely attention to problems as they arise, actually talking to taxpayers about their individual problems, and helping taxpayers to comply with the tax laws.

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

1. 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).

<sup>57</sup> IRM 5.1.11.6.3.1 (Jan. 15, 2010). See also 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*, *supra*.

<sup>58</sup> See National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 40-70 (TAS Research Study: *An Analysis of the IRS Collection Strategy: Suggestions to Increase Revenue, Improve Taxpayer Service, and Further the IRS Mission*); see also 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*, *supra*.

<sup>59</sup> Response to TAS information request (Sept. 28, 2011).

<sup>60</sup> See National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 40-70 (TAS Research Study: *An Analysis of the IRS Collection Strategy: Suggestions to Increase Revenue, Improve Taxpayer Service, and Further the IRS Mission*).

2. Revise the IRM to require additional attempts at personal taxpayer contact before the ACS takes an enforcement action or sends a case to the Collection queue.
3. Before defaulting an existing installment agreement or establishing a new streamlined IA (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.

### IRS COMMENTS

The IRS uses a multi-faceted collection strategy to effectively maximize impact with available resources. This strategy includes issuance of notices and direct contact with taxpayers both telephonically and face-to-face. The IRS agrees that personal contact is an important part of assisting taxpayers to become compliant in both filing and paying their federal tax obligations; however, it is not the only effective means of providing information to taxpayers. If a taxpayer responds to one of the many notices issued, our campus collection employees are helpful and efficient in resolving the account. If a taxpayer does not provide contact information or respond to the multiple notices issued, then the IRS must initiate the next most cost-effective action.

In order to assist taxpayers with understanding their federal tax obligations, the IRS's Office of Taxpayer Correspondence (OTC) has worked closely with the Collection function on its notice redesign efforts over the last few years. The redesigned notices provide clearer, plainer language. This will result in more engagement with the taxpayer through higher response rates and liabilities collected earlier in the process (*e.g.*, installment agreements). The majority of collection notices were redesigned and implemented in January 2011. At this time, the impact cannot be quantified, but the OTC comprehension and perception testing showed an increase in understanding of notices by taxpayers.

The IRS strives to make communication clearer so the taxpayer understands and then can choose the appropriate option based on their unique situation. In the notice redesign, information was added about installment agreements earlier in the notice stream. On IRS.gov, we have included a web page, "Understanding Your IRS Notice or Letter," which includes a page for each redesigned notice that provides specific information about that notice including actions to take, Questions and Answers, Tips, and links to resources about payment options. In addition, the IRS is working on the redesign of Publication 594, *The IRS Collection Process*, which will provide clear and simple information on the collection process as well as payment options.

The IRS has also updated collection web pages on IRS.gov to provide improved information to taxpayers by expanding available resources; ensuring language is clear; creating collection links on the home page; creating a collection topics page; increasing the number of direct links to collection topics; and streamlining the process for paying tax liabilities online. The IRS developed and posted to IRS.gov a series of collection videos titled "Owe

Taxes? Understanding IRS Collection Efforts.” These videos were designed to improve taxpayer satisfaction by providing taxpayers with information they can use to resolve their collection issues independently as well as highlighting what they can expect when working with the IRS. The videos emphasize to the viewer the importance of communicating with the IRS and what information to have available when communicating with IRS about case resolution. Presented from the taxpayer’s perspective, the videos use clear language with many references to additional information.

In addition, the IRS has a self-help option on IRS.gov called Online Payment Agreement (OPA). The use of this web application enables taxpayer convenience in their home or office to do the following:

- Arrange for a short-term extension (11-120 days);
- Arrange monthly payments via payroll deduction or direct debit installment agreement (DDIA); and
- Revise existing agreements by:
  - Changing payment due date and/or amount;
  - Change existing extensions to a regular IA or DDIA; or
  - Change existing regular IAs to a Payroll Deduction IA or a DDIA.

The OPA application is available 24 hours a day, seven days a week.

A trend worth noting is that some taxpayers no longer publish their phone numbers or use landlines. Taxpayers are increasingly using cell phones as their only source of contact, which impedes the IRS in researching telephone numbers in an attempt to contact them. The IRS currently spends millions of dollars a year, through our Locator Service Contracts, attempting to locate new telephone numbers and addresses on taxpayers who no longer reside at their last known address. The IRS also licenses the National Change of Address data from the United States Postal Service (USPS). This database contains updated change-of-address information and is received regularly from USPS.

It is important to note, while cases are in the queue, they do receive an annual notice and are subject to refund offsets. As there is a finite amount of inventory that can be processed with our current staffing, there will continue to be a need for the queue based on resources available.

As mentioned earlier, the IRS uses a variety of methods as part of its overall collection strategy. To balance our staff and prioritize our inventory, the systemic predictive dialer calls are included as part of the overall collection strategy. The IRS balances cost and taxpayer burden in determining the best methodology to reach taxpayers who owe taxes. When taxpayers respond to their tax issues as they arise, and speak with the IRS about their individual problems, they are resolved quicker and with less expense. For this reason, the IRS

provides toll-free numbers and encourages taxpayers to contact us with any concerns in our early notifications to taxpayers.

The National Taxpayer Advocate makes three preliminary recommendations in the draft report. The IRS will take or has taken the following actions with respect to these recommendations:

The IRS agrees with running manned predictive dialer tests on accounts that already reside on the ACS system; however, based on current resources, we do not believe the cost of staffing additional predictive dialer calls that do not reside on the ACS system would be worth the potential benefits. Handling return calls for messages left by the predictive dialer would require shifting of personnel from their current activities assisting other taxpayers.

Based on current staffing and resources, requiring ACS employees to attempt personal taxpayer contact prior to taking an enforcement action, or sending the case to the Collection queue, is not practical at this time as we believe that the costs likely would outweigh any potential benefits. These costs include diverting the ACS employees from other calls of taxpayers asking for information. As always, the IRS will continue to look for ways to enhance our collection processes.

Prior to defaulting any existing installment agreement, the IRS does issue a notice to the taxpayer providing them the opportunity to either appeal it or contact the IRS to revise or reinstate their agreement. When the IRS receives correspondence in which a taxpayer requests an installment agreement, but does not provide a proposed monthly payment amount, we establish the installment agreement at the lowest streamline amount as a convenience. Otherwise, the taxpayer would remain in the collection stream and may be subject to further collection actions. The IRS is in the process of providing more clarity around this issue in the next version of the Form 9465, *Installment Agreement Request*.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate recognizes that the IRS must balance many competing concerns — it must collect billions of dollars from millions of taxpayers with limited resources, balancing the cost and benefits of providing quality service to taxpayers while collecting delinquent tax balances. The IRS has achieved moderate success with its current collection process by sending notices in the early stages of delinquency. However, the IRS misses opportunities to resolve accounts quickly and efficiently when it puts the onus of personal contact primarily on taxpayers.

Even during this time when our government is tasked with the difficult challenge of trying to accomplish more with fewer resources, the IRS can do a better job of allocating its resources more effectively. In its response, the IRS agrees that personal contacts are an important means to assist taxpayers in achieving filing and payment compliance. However, the IRS assumes that calling taxpayers before taking an enforcement action, putting them in the collection queue, or defaulting an installment agreement, is not a good use of its resources. Yet it has not launched any pilot programs to test its assumptions and determine if these approaches are in fact more cost-effective — both immediately and in the long-term — than its current approach of waiting for taxpayers to call or just letting accounts languish in the IRS collection inventory.

In the limited circumstances in which the IRS has employed personal taxpayer contact, such as in its streamlined Centralized Offer in Compromise pilot program, the data seem to indicate that the IRS may be undervaluing the effectiveness of such methods in resolving taxpayer collection issues. In the past year, the IRS has expanded the streamlined process twice, and with good reason. Since the streamlined process was implemented, the IRS has been accepting approximately one-third of offers — compared to about one-fourth previously.<sup>61</sup> More importantly, the use of personal contacts with taxpayers through the pilot program led to fewer unresolved accounts moving to Appeals, and fewer offers rejected.<sup>62</sup> These results contradict the IRS's assumptions about the utility of early personal contact.

The National Taxpayer Advocate remains extremely concerned about the IRS's use of the collection queue. Merely sending annual reminder notices (which are required by statute<sup>63</sup>) and offsetting refunds while a case lingers for years is unsatisfactory. The dollar value of cases assigned to the queue has doubled in the last six years, to over \$56.2 billion at the end of FY 2011. The IRS agrees that when taxpayers speak to them about their individual problems, their tax issues are resolved more quickly and with less expense. The disagreement is simply over who should be initiating the phone call, and the growing, aging queue indicates that it should be the IRS doing so.

<sup>61</sup> IRS, Collection Activity Report NO-5000-108 (Oct. 2011). In FY 2011, The IRS accepted 19,562 offers, up 41 percent over FY 2010.

<sup>62</sup> *Id.* The overall rejection rate for FY 2011 was 20 percent, down from 25 percent in FY 2009.

<sup>63</sup> IRC § 7524.

The IRS response notes that a growing number of taxpayers rely solely on cell phones as their primary means of communication and the IRS sometimes encounters difficulties in reaching those taxpayers. This change in the communication landscape presents a challenge to the private and public sector alike. Cell phones offer a greater range of communication options than land lines; however, obtaining accurate contact information for taxpayers may require a new approach. The IRS must work today to develop a strategy to reach taxpayers of the future. As part of this strategy, the IRS should examine how others in the private and public sector are communicating with taxpayers via cell phone and consider some of the available options. Additionally, the IRS should convene a task force to study how best to communicate with taxpayers who solely have cell phones. These are the taxpayers of the future and the IRS cannot give up on communicating with them simply because technology poses a challenge.

The National Taxpayer Advocate applauds the IRS's use of a multi-faceted collection strategy in order to accommodate the wide variety of taxpayers it services. The notice stream is a key element of that strategy, and the IRS has worked diligently to make taxpayer communication clearer by revising many notices and publications, and has increased accessibility via improvements to IRS.gov. These worthwhile initiatives should be accompanied by improvements to the IRS's methods for personally reaching out to taxpayers. There are a significant number of taxpayers for which this strategy has no substitute. A more effective collection strategy would place greater emphasis on providing timely attention to problems early on and at key turning points in the collection process.

## Recommendations

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

1. 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).
2. Revise the IRM to require additional attempts at personal taxpayer contact before the ACS sends a case to the collection queue.
3. Conduct a study on how best to reach taxpayers with cell phones, including an analysis of how the private and public sectors reach customers.
4. Before allowing an existing installment agreement to default or establishing a new streamlined 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.

## MSP #18

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

### RESPONSIBLE OFFICIAL

Richard E. Byrd Jr., Commissioner, Wage and Investment Division

### DEFINITION OF PROBLEM

The Federal Payment Levy Program (FPLP) is an automated system that matches IRS records against those of the government's Financial Management Service (FMS) and allows the IRS to issue continuous levies for up to 15 percent of federal payments due to taxpayers who have unpaid federal liabilities.<sup>1</sup> In January 2011, the IRS began applying a low income filter (LIF) to the FPLP to screen out taxpayers whose incomes are below 250 percent of the federal poverty level set by the Department of Health and Human Services.<sup>2</sup> This filter protects low income taxpayers from experiencing an economic hardship due to a levy on their Social Security old age or disability benefits and to ensure that the IRS does not issue levies that it would likely have to release immediately on the grounds of economic hardship.<sup>3</sup>

The National Taxpayer Advocate had urged the IRS for several years to implement this filter and is generally pleased with its development.<sup>4</sup> This filter has reduced the number of TAS FPLP cases.<sup>5</sup> However, its effectiveness has not yet been tested.<sup>6</sup> Further, the National Taxpayer Advocate is concerned that the filter still leaves some taxpayers subject to the FPLP, even though their incomes otherwise fit the guidelines.

Specifically, the filter does not protect:

- Taxpayers with delinquent unfiled returns;<sup>7</sup> and
- Taxpayers (or their spouses) who have debts on the IRS's Business Master File (BMF).<sup>8</sup>

<sup>1</sup> Internal Revenue Code (IRC) § 6331(h)(2)(A), as prescribed by the Taxpayer Relief Act of 1997 (Pub. L. 105-34) § 1024, authorizes the IRS to issue continuous levies on certain federal payments. FMS is the Department of Treasury agency that processes payments for various federal agencies. Payments subject to FPLP include any federal payments other than those for which eligibility is based on the income or assets of the recipients.

<sup>2</sup> Department of Health and Human Services, *The 2011 HHS Poverty Guidelines*, available at <http://aspe.hhs.gov/poverty/11poverty.shtml>. For 2011, an individual who makes \$10,890 or less is in poverty. This number is then multiplied by 250 percent to determine the 250 percent federal poverty threshold.

<sup>3</sup> IRC § 6343(a).

<sup>4</sup> See National Taxpayer Advocate 2007 Annual Report to Congress; National Taxpayer Advocate 2006 Annual Report to Congress 110-129, 141-156; National Taxpayer Advocate 2005 Annual Report to Congress 123-135; National Taxpayer Advocate 2004 Annual Report to Congress 26-263; National Taxpayer Advocate 2003 Annual Report to Congress 206-212; National Taxpayer Advocate 2001 Annual Report to Congress 202-209.

<sup>5</sup> Taxpayer Advocate Management Information System (TAMIS) (pulled Nov. 9, 2011). Since the IRS implemented the filter (from January through September 2011), TAS FPLP cases have declined by 26.6 percent compared to the same period in 2010.

<sup>6</sup> Email from Wage and Investment Division (W&I) senior analyst to TAS senior researcher (Oct. 11, 2011). The IRS will not complete a review of the FPLP LIF until fiscal year (FY) 2012.

<sup>7</sup> Internal Revenue Manual (IRM) 5.11.7.2.2.3(1) (Aug. 13, 2011).

<sup>8</sup> IRM 5.11.7.2.2.3(1) (Aug. 13, 2011).

In addition to questions about the effectiveness and design of the filter, the National Taxpayer Advocate has concerns about IRS policies on bank levies. The IRS can use bank levies to collect on 100 percent of a taxpayer's Social Security benefits, even if a continuous levy has been filed under the FPLP and the 15 percent limit (under IRC § 6331(h)(2)(A)) applies.<sup>9</sup> Neither the IRS nor the financial institution is required to investigate whether the funds in the account include Social Security benefits before the IRS files a bank levy, potentially creating an economic hardship for the taxpayer and running counter to Congress's efforts to limit the amount of Social Security benefits subject to levy. Using this authority may be particularly harmful now that the Department of the Treasury requires all federal payments, other than tax refunds, to be deposited with a banking institution.<sup>10</sup> If the IRS levies on a taxpayer's account, Social Security benefits are even more likely to be collected.

## ANALYSIS OF PROBLEM

### Background

#### *The Road to a Low Income Filter for the FPLP Program*

Under IRC § 6331(h)(2), the IRS has the authority to levy a variety of federal sources of income, including unemployment benefits, workman's compensation, and public assistance programs such as Supplemental Security Income. However, as a matter of policy, the IRS does not pursue these sources to collect delinquent taxes.<sup>11</sup> Most FPLP levies have historically been imposed on Social Security benefits, although the FPLP has recently been expanded to include Railroad Retirement Board benefits.<sup>12</sup> Initially, the IRS used an income filter to exclude taxpayers with income below a specified threshold from the FPLP, but the IRS gradually phased out the filter and eliminated it altogether in January 2006.<sup>13</sup> However, TAS continued to advocate for and emphasize the importance of a filter, and in response to the National Taxpayer Advocate's recommendation in past Annual Reports to Congress, the IRS worked with TAS to create the new low income filter that took effect in January 2011.

#### *The Identification of Taxpayers Who Should Be Filtered Out of FPLP Was Largely Based on a TAS Research Study, Which Developed a Proxy for Economic Hardship.*

The filter was intended to protect people likely to suffer the economic hardship described in IRC § 6343(a)(1)(D). That provision requires the IRS to release a levy when it would

<sup>9</sup> IRM 5.11.4.5 (Sept. 14, 2010). A review of IMF cases receiving an FPLP levy from January 1 until August 8, 2011 showed that over 31 percent of taxpayers who are subject to the FPLP program are also placed in the IRS Automated Collection System (ACS). Based on IMF data for taxpayers who received a levy.

<sup>10</sup> Individuals who apply for federal benefits, other than tax refunds, after May 1, 2011 must choose an electronic payment option upon enrollment. All paper check recipients who applied for benefits before May 1, 2011 are required to switch from paper checks to electronic payments by March 1, 2013. 31 C.F.R. § 208.

<sup>11</sup> IRM 5.11.7.2.1 (Aug. 12, 2011).

<sup>12</sup> IRM 5.11.7.2.1.1(2)(j) (Aug. 12, 2011). In June 2011, the IRS added Railroad Retirement Board benefits to the list of items that are subject to FPLP.

<sup>13</sup> This filter was known as the Total Positive Income (TPI) indicator and was implemented in January 2002 at the request of the National Taxpayer Advocate. For a more detailed discussion of this filter, see National Taxpayer Advocate 2005 Annual Report to Congress 123-135; National Taxpayer Advocate 2004 Annual Report to Congress 246-263; National Taxpayer Advocate 2003 Annual Report to Congress 206-212; and National Taxpayer Advocate 2001 Annual Report to Congress 202-209.

create an economic hardship due to the financial condition of the taxpayer. Treas. Reg. § 301.6343-1(b)(4) specifies that an economic hardship exists if a taxpayer cannot pay his or her basic living expenses.

When developing the filter to protect Social Security recipients, the IRS sought to determine how the Code's and regulations' definitions of economic hardship would apply to these taxpayers. Social Security benefits provide at least half of the total income for about 66 percent of aged beneficiaries and comprise 90 percent or more of total income for about 35 percent of this population.<sup>14</sup> A levy on Social Security benefits is likely to cause a hardship, and the impact may be worse during difficult economic times.<sup>15</sup>

Understanding the vulnerability of this group (*i.e.*, the elderly and disabled), TAS conducted a research study to determine how to identify when an FPLP levy would cause economic hardship for taxpayers who receive Social Security. The study, which was published in the 2008 Annual Report to Congress, found that after applying the IRS's 2008 allowable living expenses to their incomes, certain taxpayers would meet the IRS's definition of economic hardship if the IRS filed FPLP levies on their Social Security benefits.<sup>16</sup> TAS's model used taxpayers' income information from individual tax returns and payor documents supplied to the IRS to estimate the taxpayers' incomes. TAS used other tax return data to estimate the taxpayers' necessary living expenses routinely allowed by the IRS. Next, these two amounts were compared to determine the taxpayers' ability to pay the FPLP levy without experiencing economic hardship.

After conducting this analysis, TAS found that applying a screen of income not more than 250 percent of the federal poverty level excluded all taxpayers identified as experiencing hardship as a result of the levy.<sup>17</sup> Thus, the current use of the 250 percent of the federal poverty level exclusion serves as a proxy for establishing economic hardship and justifying the required levy release under IRC § 6343.<sup>18</sup> The IRS agreed with TAS that 250 percent of the federal poverty level fairly approximates the regulatory definition of significant hardship for Social Security recipients and makes it unnecessary to construct an algorithm to identify taxpayers who would experience economic hardship.<sup>19</sup>

<sup>14</sup> Social Security Administration (SSA), *Fast Facts & Figures About Social Security* (Sept. 2011).

<sup>15</sup> U.S. Census Bureau, *About Poverty Overview*, <http://www.census.gov/hhes/www/poverty/about/overview/index.html>. Recent census data showed that the number of low income citizens in 2010 was the largest number in 52 years (46.2 million).

<sup>16</sup> National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, 46 (*Building a Better Filter: Protecting Lower Income Social Security Recipients from the Federal Payment Levy Program*). See also IRM 5.15.1.7 (Oct. 2, 2009). Allowable living expenses are expenses that are necessary to provide for a taxpayer's and his or her family's health and welfare and/or production of income. The expenses must be reasonable and establish the minimum a taxpayer and family need to live.

<sup>17</sup> National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, 65 (*Building a Better Filter: Protecting Lower Income Social Security Recipients from the Federal Payment Levy Program*).

<sup>18</sup> *Id.* at 46. The study used IRS 2008 allowable living expense standards.

<sup>19</sup> Because the IRS believed this population would be unlikely to have large amounts of unreported income, the IRS was willing to use an algorithm based on IRP data. It later accepted the 250 percent of the federal poverty level as a proxy in lieu of constructing an algorithm.

### *The Final Design and Implementation of the FPLP Filter*

The LIF is designed to identify and remove from the FPLP delinquent accounts involving taxpayers whose incomes fall below 250 percent of the federal poverty level.<sup>20</sup> However, the LIF does not screen out taxpayers who meet one of the following exclusion criteria, leaving them exposed to the FPLP process even though they may experience economic hardship as a result of the levy:

1. The taxpayer's account shows delinquent unfiled tax returns under the primary Social Security number (SSN);
2. The account indicates a business debt under the taxpayer's or the taxpayer's spouse's SSN;
3. The name on the account does not match the name on the balance due module; or
4. The spouse's SSN is invalid.

Once the IRS determines a taxpayer meets one of these criteria, it does not conduct any further research into the taxpayer's situation or apply the 250 percent screen. Thus, the IRS risks imposing levies on taxpayers who will experience economic hardship, burdening them and the IRS, which must release the levy once economic hardship is established.

### **Exclusions to the LIF Filter Prevent It from Meeting Its Overall Objective and Cause Economic Hardship to Social Security Recipients.**

#### *Excluding Taxpayers with Unfiled Returns or Business Debts from the Filter Potentially Harms Low Income Taxpayers and Ignores the Tax Court's Holding in *Vinatieri*.*

As TAS recommended during the development of the LIF, the IRS should apply the filter to taxpayers who have unfiled returns or business debts (but meet all other exclusion criteria) and then analyze each case to see if it can be resolved. However, despite TAS's objections, the IRS has declined to apply the LIF to taxpayers with unfiled returns and business debts, all but guaranteeing that low income Social Security recipients will be harmed. In a representative sample of 435 cases where taxpayers are subject to the FPLP and have an unfiled return,<sup>21</sup> TAS found that 20.7 percent were below 250 percent of the poverty level.<sup>22</sup> These numbers illustrate that the IRS's current approach is harming taxpayers and raises concerns addressed in the *Vinatieri* case.<sup>23</sup>

In *Vinatieri*, the court held that proceeding with a levy would be unreasonable because IRC § 6343(a)(1)(D) (the economic hardship provision) would require its immediate release, and a levy that would cause demonstrated economic hardship had to be released even

<sup>20</sup> IRM 5.11.7.2.2.3 (Aug. 12, 2011).

<sup>21</sup> These cases had a levy sent or levy proceeds received during January 2011 through October 15, 2011).

<sup>22</sup> The sample has a confidence level of 95 percent with a margin of error (plus or minus) of about 4.7 percent.

<sup>23</sup> *Vinatieri v. Comm'r*, 133 T.C. No. 16 (2009). The taxpayer's financial information showed that she could not pay her basic living expenses if the IRS levied on her wages. The settlement officer concluded that the levy would create an economic hardship but still proceeded with the levy because the taxpayer had not filed her 2005 and 2007 returns.

though the taxpayer had unfiled returns. Therefore, the determination to proceed with the levy was arbitrary, and the Court held the determination was incorrect as a matter of law and was an abuse of discretion.<sup>24</sup>

Similarly, when the IRS fails to filter out of the FPLP taxpayers whose incomes fall below 250 percent of the federal poverty level (the proxy for economic hardship under IRC § 6343(a)(1)(D)) because of an unfiled return or a business debt, it will have to release the levy later when the taxpayer shows that he or she is experiencing hardship as a result. That is, the IRS is unnecessarily harming low income Social Security recipients, because it could presume the presence of hardship if it looked at the income levels of taxpayers who had unfiled returns or a business debt instead of automatically excluding them from the LIF. Once the presence of economic hardship is fairly presumed, denying these taxpayers the benefit of the LIF contravenes the holding in *Vinatieri*.

In discussions with TAS on this issue, the IRS has indicated that a taxpayer's income dropping below the poverty level does not necessarily fall within the parameters of "economic hardship" set out in Treas. Reg. § 301.6349-1(b)(4).<sup>25</sup> However, the IRS worked carefully with TAS to design a filter – based on 250 percent of the federal poverty level – that would act as a proxy for economic hardship. Applying this proxy to taxpayers with filed returns, but not to those with unfiled returns or business debts, can cause economic harm for those taxpayers. This decision is contrary to the purpose for which the filter was created: to prevent Social Security recipients from experiencing economic harm. It makes even less sense since the IRS and its executives (including the then-Deputy Commissioner for Services and Enforcement) agreed with TAS that using 250 percent of the federal poverty level as a filter obviated building an algorithm to identify taxpayers who would experience hardship. Excluding nonfilers and businesses with tax debts defies logic and ignores the rationale of *Vinatieri*.

The IRS should look at the income of a taxpayer with an unfiled return or business debt before placing him or her back into the FPLP, and if the income falls below 250 percent of the federal poverty level, the IRS should filter the taxpayer out of FPLP, acknowledging that a levy would cause a hardship. The IRS also should try to resolve the unfiled return or business debt issue.

### *The IRS Collects on a Taxpayer's Liability Even When Excluded from FPLP.*

Filtering taxpayers out of the FPLP does not mean the IRS does not collect on their debts through refund offsets.<sup>26</sup> In fact, the IRS collected about \$1.5 billion through offsets in

<sup>24</sup> *Vinatieri v. Comm'r*, 133 T.C. No. 16 (2009). The taxpayer's financial information showed that she could not pay her basic living expenses if the IRS levied on her wages. The settlement officer concluded that the levy would create an economic hardship but still proceeded with the levy because the taxpayer had not filed her 2005 and 2007 returns.

<sup>25</sup> Treas. Reg. § 301.6343-1(b)(4). An economic hardship condition exists when a levy will cause an individual to be unable to pay his or her reasonable living expenses. A determination as to reasonable living expenses will be made by an IRS director, considering information provided by the taxpayer.

<sup>26</sup> IRC § 6402.

2011.<sup>27</sup> Therefore, revising the LIF exclusion criteria to include taxpayers who have an unfiled return or an unpaid business debt does not necessarily mean the debt will go unpaid. The LIF exclusion simply prevents a levy from being filed against a low income taxpayer who could not pay basic living expenses if the IRS issued the FPLP levy.

### **The IRS's New FPLP Levy Release Procedures Will Prevent Additional Economic Harm to FPLP Taxpayers.**

In meetings with the IRS, TAS raised concerns about the timing of FPLP levy releases. For instance, a taxpayer's income may change after being subject to FPLP levies, causing him or her to be filtered out of the process. However, FMS may continue taking a portion of the taxpayer's Social Security benefits after the filter has applied due to a delay in the interaction between IRS and FMS systems.<sup>28</sup> Previously, there was no specific guidance to address this situation. TAS recommended that the amount collected after the levy release be returned to the taxpayer, and the IRS subsequently advised employees that they should generally return levy proceeds in these situations.<sup>29</sup> The IRS also agreed to change guidance to clarify that if TAS has an open case and requests a collection hold on the account, it may be necessary to block or release the FPLP levy until the case is resolved;<sup>30</sup> and if a Revenue Officer decides a taxpayer should not be part of FPLP, he or she needs to request a block or release on the levy.<sup>31</sup> The National Taxpayer Advocate is pleased that the IRS has adopted TAS's recommendations in its guidance.

### **Taxpayers' Social Security Benefits Are Subject to Numerous IRS Collection Actions.**

The IRS's policies reflect its position that it is authorized to file either a continuous levy under IRC § 6331(h)(2)(A), collecting on up to 15 percent of the taxpayer's Social Security benefits,<sup>32</sup> or a "paper" levy collecting 100 percent of the benefits.<sup>33</sup> The National Taxpayer Advocate is concerned that permitting a paper levy to collect 100 percent of a taxpayer's Social Security benefits does not reflect Congress's desire to limit collection against such benefits. In the 2009 Annual Report, she recommended that Congress impose a 15 percent limit on all types of Social Security levies.<sup>34</sup>

<sup>27</sup> TAS research used the IMF to identify who received a FPLP levy and who had refund offsets. The \$1.5 billion collected through refund offsets was part of a total of about \$18 billion in total liabilities in the FPLP program. Individual Master File refunds offset during 2011 and Account Receivable Dollar Inventory File.

<sup>28</sup> IRM 21.4.4.3.4 (Oct. 1, 2007). See also IRM 5.11.7.2.6 (7) (Aug. 12, 2011) for a description of the interface between the FPLP program and FMS when a FPLP levy is served to FMS.

<sup>29</sup> IRM 5.11.7.2.7 (Aug. 12, 2011).

<sup>30</sup> IRM 5.11.7.2.4 (Aug. 12, 2011).

<sup>31</sup> IRM 5.11.7.2.5 (Aug. 12, 2011).

<sup>32</sup> IRC § 6331(h)(2)(A).

<sup>33</sup> IRM 5.11.7.2.5.1 (Aug. 12, 2011).

<sup>34</sup> See National Taxpayer Advocate 2009 Annual Report to Congress 371 (Legislative Recommendation: *Apply Uniform Limits and Extensions to Levy Actions on Social Security Benefits*).

In addition to the IRS having two methods to directly collect on a taxpayer's Social Security benefits, it may also be able to reach taxpayers' benefits by levying on taxpayers' other assets, including their bank accounts.<sup>35</sup> This collection action could impact taxpayers who have either been filtered out of the FPLP program by the LIF or are subject to a 15 percent levy. In fact, 31 percent of taxpayers who are subject to the FPLP program are also placed in the IRS Automated Collection System.<sup>36</sup> Further, collection employees are not instructed to investigate whether a taxpayer has been excluded from the FPLP by the LIF or is subject to FPLP prior to taking collection action. Proceeding with collection and filing a levy that would attach to a taxpayer's bank account could lead to the collection of a taxpayer's Social Security benefits, if the account holds them.<sup>37</sup> This type of scenario may be more likely now that all Social Security recipients receive their checks electronically.<sup>38</sup> The following examples illustrate the harm that these levies can cause:

**Example One:** A taxpayer is filtered out of the FPLP because his income falls below 250 percent of the federal poverty level, and his case returns to the normal IRS collection system. An IRS employee does not check to see if the taxpayer has been subject to FPLP or filtered out of the program by the LIF, and files a levy that attaches to the taxpayer's bank account, which holds his direct-deposited Social Security benefits.

**Example Two:** Fifteen percent of the taxpayer's Social Security benefit is levied through FPLP. The remaining 85 percent is directly deposited into the taxpayer's bank account, which is subject to a levy.<sup>39</sup>

*Before Taking Additional Collection Actions, the IRS Should Review Cases and Determine if the Taxpayer Is Subject to the FPLP Program or Has Been Filtered Out of the Program by the LIF.*

In an effort to prevent the situations above, the IRS should review each case before taking additional collection actions to find out if the taxpayer has been subject to the FPLP or filtered out. This review can be conducted through use of a systemic filter. If either situation exists, the IRS should evaluate the taxpayer's case and determine if he or she is eligible for an offer in compromise (OIC) or currently not collectible (CNC) status.

<sup>35</sup> IRC § 6331(a). See also *United States v. Marsh*, 89 F. Supp. 2d 1171, 1179 (D. Haw. 2000). IRC § 6331(h) "expand[ed] the right of the IRS to levy amounts previously exempt from levy"; however, this provision did not limit the IRS's existing authority to impose levies.

<sup>36</sup> TAS research used the following IRS databases to conduct this analysis: (1) Individual Master File Transaction history and (2) Status Code History Files for taxpayers who received a levy or had levy proceeds attached by the IRS as of August 8, 2011.

<sup>37</sup> IRC 6331(a). A levy can also attach to a stream of payments from a 401(k) plan, a certificate of deposit, or royalties.

<sup>38</sup> The Treasury Department has recently stopped issuing paper checks for all federal benefits. Individuals who apply for benefits after May 1, 2011 must choose an electronic payment option upon enrollment. All paper check recipients who applied for benefits before May 1, 2011 are required to switch from checks to electronic payments by March 1, 2013. These benefits will either be directly deposited into a bank account or into a debit card account. 31 C.F.R. § 208.

<sup>39</sup> IRC § 6331(a); IRM 5.11.4.5 (Sept. 14, 2010).

*The IRS Should Adopt Procedures Similar to Those in a Recent Treasury Regulation and the Debt Collection Improvement Act of 1996 and Exclude a Portion of Social Security Benefits from Collection.*

If the IRS files a 15 percent FPLP levy against a taxpayer and after reviewing the case decides to file another levy, it should ensure that a portion of the taxpayer's Social Security benefits is not subject to this second levy. The IRS could accomplish this by adopting an approach similar to that of a recent Treasury regulation, which requires financial institutions to investigate whether exempt benefits were directly deposited into a taxpayer's account before garnishing the funds for creditors other than the United States, among others.<sup>40</sup> If such benefits are in the taxpayer's account, a portion of the benefits must remain available to the taxpayer.<sup>41</sup> Although this regulation excludes levies issued by the United States or by state child support enforcement agencies, it does provide a framework for reconsideration of IRS policy on collecting benefits through bank levies.

Congress has adopted a comparable approach for nontax debts in the Debt Collection Improvement Act of 1996 (DCIA), which acts as a safeguard against excessive collection on an individual's Social Security benefits from those who are experiencing an economic hardship.<sup>42</sup> The IRS should adopt the general principle of protecting taxpayers' Social Security benefits, and more specifically the approach set out in the recent Treasury regulation, by working with financial institutions to determine what portion of the funds in the account are Social Security benefits and exclude a portion of those benefits from the levy. The IRS could do this by stating in the levy notice that the levy applies up to the amount of the tax debt, but if the account has received Social Security benefit payments, two months worth of benefits must be deducted from the tax debt. Adoption of this approach is especially prudent here since the IRS knows this is a vulnerable group of taxpayers who may also experience cognitive difficulties.

## CONCLUSION

The National Taxpayer Advocate is pleased that the IRS has implemented the FPLP low income filter, but believes it should be extended to taxpayers who have unfiled returns or business debts. Denying the LIF to these taxpayers effectively undermines the LIF and its primary objective. Additionally, once it excludes taxpayers from the FPLP, the IRS should refrain from any other collection action against these taxpayers. A further review of IRS collection policies regarding bank levies and their possible impact on Social Security benefits is necessary to address possible hardship situations.

<sup>40</sup> 31 CFR § 212.3. In this regulation garnishment includes a written order by either a court or a state child support agency.

<sup>41</sup> 31 CFR § 212. If the institution discovers exempt benefits, it must allow the account holder access equal to two months of payments or the current balance of the account, whichever is lower.

<sup>42</sup> Pub. L. No. 104-134 (1996); 31 U.S.C. § 3701 *et seq.* The DCIA provides that \$9,000 (\$750 times 12 months) of the debtor's annual Social Security benefit is exempt from offset. 31 U.S.C. § 3716(c)(3)(A)(ii). The regulations further limit the offset amount to the lesser of "(i) The amount of the debt . . . ; (ii) An amount equal to 15 percent of the monthly covered benefit payment; or (iii) The amount, if any, by which the monthly covered benefit payment exceeds \$750.00." 31 C.F.R. § 285.4(e).

## IRS COMMENTS

The IRS must continually balance the interests of taxpayers with our responsibility to collect federal taxes that are owed to the government. The IRS is committed to continually improving the Federal Payment Levy Program. As noted by the National Taxpayer Advocate, the IRS made FPLP policy and procedural changes to assist possible low income taxpayers by implementing the Low Income Filter and issuing additional guidance on FPLP levy releases.

The FPLP LIF was developed to determine which low income Social Security Administration taxpayers and Railroad Retirement Benefit beneficiaries should be excluded from the FPLP program. The use of the LIF is not a proxy for an economic hardship determination, nor is it determinative of whether the taxpayer has the ability to pay the delinquent taxes through any other collection means. The purpose of the LIF is to make a determination whether to use the FPLP to collect the liability. The taxpayers who bypass the FPLP program due to the LIF are processed through normal collection procedures. These normal procedures may include contact by an IRS employee or collection action, such as a levy.

The IRS decision to use 250 percent of the poverty level guidelines as the basis of whether or not to levy through FPLP was to ensure consistency with other collection alternative processes. The same poverty level guideline is used to determine if a taxpayer can afford to pay an offer-in-compromise (OIC) application fee or an installment agreement fee.

The National Taxpayer Advocate makes reference to the *Vinatieri* court case where a levy should be released if a case meets the economic hardship provision, even though there were unfiled returns. The IRS believes that this court case is not relevant to the FPLP LIF analysis since the LIF is not determinative of economic hardship or inability to pay. For an economic hardship determination to be made, all taxpayers (whether above or below the LIF income threshold) must provide a financial statement to the IRS since many taxpayers receive other income and assets of value. The FPLP LIF simply recognizes the indication of possible low income, which will still require taxpayer contact to make a hardship determination. If a hardship determination is made, the employee will follow the procedures established based on the *Vinatieri* decision.

The current FPLP LIF addresses a Government Accountability Office (GAO) report,<sup>43</sup> which concluded the methodology used to estimate income in the previous FPLP low income filter was problematic. The decision to not allow a taxpayer with delinquent tax returns or delinquent (sole proprietor) business tax debts to go through the FPLP LIF analysis was made to ensure that the most accurate and up-to-date information about a taxpayer is used in the analysis.<sup>44</sup> The determination whether a taxpayer has low income is based either

<sup>43</sup> GAO, GAO-03-356, *Federal Payment Levy Program Measures, Performance, and Equity Can Be Improved* (Mar. 2003).

<sup>44</sup> The exclusion of these two areas is consistent with a recommendation by GAO in its 2003 report.

from the latest current year tax return or third-party reporting information. An important aspect in the LIF was to build or formulate an estimated income for the taxpayer using the most accurate and most current income information. If the FPLP were to include taxpayers with delinquent unfiled returns in the LIF analysis, then the FPLP may be relying solely on third party information without the benefit of allowing a taxpayer to provide their own tax return information, and also most recent information, to use as a basis for estimated income. To ensure the LIF uses the most accurate income information available, taxpayers with delinquent returns remain in FPLP and are put through the LIF once the delinquent returns are filed. In addition, the LIF does not have the capability of reconciling all information with respect to delinquent taxpayers with business tax debts; therefore, these cases must be excluded from the automatic determination.

In the draft report, the National Taxpayer Advocate makes conclusions from a sampling of FPLP taxpayers with delinquent unfiled returns. The IRS was informed that there is no official study or report on this sampling available for our review. Based on a discussion in which TAS explained its methodology, this sampling did not include FPLP taxpayers with business debts. Therefore, there is no documentation on which to rely to conclude taxpayers with business debts should be removed from the LIF.

The IRS will consider the views of the National Taxpayer Advocate as we analyze whether improvements in this area are warranted. The IRS is beginning a review of the LIF income model to determine the accuracy of the estimated income formula in comparison to a taxpayer's actual financial information. The IRS will assess the impact of excluding taxpayers with outstanding delinquent returns and business debts from the LIF. Small Business/Self-Employed Research will assist in completing this more in-depth analysis of the LIF model to determine its accuracy. Any changes to the program will take place after a careful analysis is completed to determine whether the estimated income model varies greatly from a taxpayer's true financial condition.

The National Taxpayer Advocate makes four preliminary recommendations regarding the FPLP. The IRS is taking or has taken the following actions with respect to the recommendations:

While we continue to take into account the recommendations made in the draft report, at this time the IRS does not believe it is appropriate to eliminate criteria that exclude taxpayers with unfiled delinquent returns or business debts from the FPLP LIF. The LIF is not able to make an accurate calculation of low-income for taxpayers with delinquent returns or business debts. Once the delinquency is resolved, the LIF will be utilized.

The IRS does not agree a review is necessary in all cases, before taking any further collection action, to determine if the taxpayer is a good candidate for the streamlined OIC process or meets currently not collectible criteria when a taxpayer is subject to a 15 percent FPLP levy, or has been filtered out of FPLP by the LIF. As previously discussed, the LIF fails to take into consideration the taxpayer's current assets and equity in those assets which

results in an incomplete picture of the taxpayer's true financial condition. An OIC requires the submission of a current financial statement to verify the taxpayer's financial position. Similarly, the IRS cannot determine if a taxpayer meets CNC criteria without a current financial statement. As with all taxpayers who have unpaid taxes, the IRS will work with taxpayers in this situation to determine if they are eligible for streamlined OICs or if they meet CNC criteria.

The IRS does not believe it should refrain from collection action based solely on a case being filtered out of FPLP. The LIF is only an indicator and does not provide the financial information needed to make accurate and complete financial conclusions. The LIF fails to take into consideration current equity in assets. The complete financial statement, which serves as the basis for the taxpayer's OIC and CNC determination, provides a true picture of the taxpayer's current financial situation, including possible sources of equity in assets which can be used to satisfy the taxpayer's tax liability.

The IRS is mindful of economic hardship issues, but does not believe that it is appropriate to revise the levy notice to financial institutions to exempt a portion of the taxpayers Social Security benefits from levy in all cases. Prior to issuing a notice of levy the IRS attempts multiple contacts with the taxpayer through notices and phone calls or face-to-face meetings to determine the taxpayer's ability to pay the tax liability. If the taxpayer is unresponsive, or chooses not to cooperate, the IRS will consider issuing a notice of levy in an attempt to bring the case to resolution. If the taxpayer is not cooperative, the IRS will not know if the Social Security benefits are the taxpayer's sole source of income. IRS internal guidance procedures address economic hardship pursuant to Internal Revenue Code (IRC) § 6343(a)(1)(D) where a taxpayer's income is deposited into a bank account and all the money is attached by a notice of levy.<sup>45</sup> If the IRS determination is that a notice of levy on the taxpayer's bank account causes the taxpayer to be unable to pay reasonable basic living expenses, thus creating an economic hardship, IRC § 6343(a)(1)(D) requires immediate release of such notice of levy causing the economic hardship.

<sup>45</sup> IRM 5.11.4.5(2) ("When an entire paycheck is deposited, an economic hardship may exist because all of the money is levied. If this happens, release the levy in whole or in part, as appropriate, to avoid creating an economic hardship....").

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate is generally pleased with the recent implementation of the FPLP filter and knows it will help many taxpayers who would otherwise experience hardship while reducing significant IRS rework. Further, the National Taxpayer Advocate is encouraged that the IRS will research the effectiveness of the filter and expects that the IRS will include TAS in this evaluation. However, in its response, the IRS is attempting to rewrite history by declaring that “[t]he use of the LIF is not a proxy for an economic hardship determination.” The National Taxpayer Advocate cannot allow this mischaracterization to stand.

The National Taxpayer Advocate was personally involved in all aspects of the negotiations surrounding the implementation of the LIF. She personally briefed the Deputy Commissioner of Services and Enforcement and the Commissioner of Wage and Investment, and personally worked with the W&I Director of Campus Compliance to put the LIF into effect. The IRS agreed with TAS that for the Social Security population — composed of the elderly and disabled persons — there was a low risk of significant unreported income. In other words, most of the income of this population would be reported to the IRS through third-party reporting. Therefore, the IRS could use Information Returns Processing (IRP) data to reconstruct this population’s income with a high degree of accuracy.

In the TAS study, after establishing the taxpayer’s income through the most recent return or IRP data, TAS used the taxpayer’s household size to determine the amount of allowable and necessary expenses under the IRS’s own schedules. These are the very same schedules IRS personnel use to calculate installment agreement or OIC terms or to determine whether a taxpayer should be put into CNC status.<sup>46</sup> Thus, for purposes of the TAS study, a “determination” was made in each case as to whether the taxpayer met the IRS definition of economic hardship and thus should be excluded from the FPLP levy program, since the IRS would be *required* to release the levy under IRC § 6343.

In their discussions, the National Taxpayer Advocate and IRS senior leaders considered the possibility of building an algorithm that would pull in the taxpayer’s return or IRP data and compare that total to the allowable and necessary living expenses for that income and household category. In lieu of building such a challenging algorithm, IRS senior leadership requested the National Taxpayer Advocate identify an easy-to-apply poverty level factor that could be screened against the taxpayer’s household size and income as reported on the most recent year’s tax return or IRP data. After several runs of different poverty-level factors, the IRS Deputy Commissioner for Services and Enforcement determined that 250

<sup>46</sup> IRM 5.11.7.2.2.3(1) (Aug. 12, 2011). The definition of economic hardship under IRC § 6343 is broader than “allowable and necessary”, so by using the latter schedules, TAS applied a more conservative standard in its test.

percent of the federal poverty level (FPL) was the best measure to ensure that no taxpayer who met the definition of economic hardship would be subject to an FPLP levy.

In fairness, the decision to use 250 percent FPL as a proxy for economic hardship was made before the Tax Court issued its opinion in *Vinatieri*. But the sole basis for the IRS using 250 percent FPL was not, as the IRS inaccurately asserts, “to ensure consistency with other collection alternative processes.” The reason for using 250 percent FPL was that it excluded from the FPLP those taxpayers for whom it had been determined, under IRS procedures, to meet the definition of economic hardship. The use of the LIF filter was based on a statistically representative study of FPLP taxpayers receiving Social Security benefits, and the establishment of 250 percent FPL as the filter level was derived from the actual results of that study. The IRS cannot stand history on its head and ignore the well-documented basis for this decision, at least not as long as this National Taxpayer Advocate is around.

The National Taxpayer Advocate agrees that the LIF does not take into consideration equity in assets — nor do the IRS’s procedures for determining whether a taxpayer meets CNC-hardship status. She concedes that it is possible for a taxpayer to be excluded from FPLP by the Low Income Filter even though he or she may have significant assets. In fact, the TAS study attempted to reconstruct the asset picture for taxpayers in its study by identifying those who had real estate or who received significant amounts of investment income, which would indicate a large corpus generating that income. It was the IRS that chose not to develop an algorithm that would factor in this information.

Nevertheless, the National Taxpayer Advocate agrees that where a taxpayer has been excluded from FPLP on the basis of the LIF, the IRS should have the ability to run that account through its normal collection processes. She notes, however, that when W&I reviewed the results of our study, the then-Director of W&I Campus Compliance noted that at least half of the taxpayers in TAS’s study who were actually being levied upon in FPLP would be under the “tolerance” level for the Automated Collection System (ACS) and would not be selected for collection. Thus, the National Taxpayer Advocate is unclear as to why the IRS is so insistent today on going after this group of taxpayers.

However, allowing for the fact that one-half of the excluded base of FPLP taxpayers might meet the criteria for assignment to ACS, what the National Taxpayer Advocate is proposing is a “rule of reason.” That is, the IRS should look at these taxpayers, who have already been screened to meet the level of economic hardship, and see whether they are good candidates for OICs or streamlined IAs. We are proposing that the IRS reach out and communicate with these taxpayers, since we have very good evidence that they are in the highest risk group for incurring economic hardship as a result of our enforced collection actions.<sup>47</sup> We

<sup>47</sup> The National Taxpayer Advocate respectfully disagrees with the IRS’s statement that “[p]rior to issuing a notice of levy the IRS attempts multiple contacts with the taxpayer through notices and phone calls or face-to-face meetings to determine the taxpayer’s ability to pay the tax liability.” See Most Serious Problem: *The IRS Does Not Emphasize the Importance of Personal Taxpayer Contact as an Effective Tax Collection Tool*, *supra*, for an extensive and detailed discussion of just how often the IRS fails to make effective, personal contacts with taxpayers.

are not proposing that the IRS automatically put these taxpayers into IAs or OICs. In fact, what we are suggesting is consistent with the Commissioner's vision for his "Fresh Start" initiative, which advocates for more expansive use of OICs and streamlined IAs.<sup>48</sup>

#### **The Current LIF Exclusion Criteria May Violate *Vinatieri*.**

The National Taxpayer Advocate disagrees that the *Vinatieri* case is not relevant to FPLP LIF situations and is disappointed that the IRS will not adapt the LIF to the principles that this case relies upon (*i.e.*, that proceeding with a levy is unreasonable when IRC § 6343(a)(1)(D) would require its immediate release, and that a levy that caused economic hardship had to be released even though a taxpayer had unfiled returns). The IRS is incorrect in stating that "[f]or an economic hardship determination to be made, all taxpayers . . . must provide a financial statement to the IRS." The burden of providing financial statements is precisely what the LIF is designed to address. Since the FPLP LIF presumes economic hardship, denying the benefit of the filter to taxpayers who fall within its income guidelines, but have an unfiled return, ignores the holding in *Vinatieri*. To abide by the spirit of *Vinatieri*, the IRS should not subject taxpayers to the FPLP (or any other collection action) once they have been identified by the LIF, regardless of filing status or outstanding business liabilities, unless the IRS has obtained new information that reveals additional sources of income for the taxpayer. Preferably, this information should be obtained through personal contact with the taxpayer.

#### **Having the IRS Make a Hardship Determination Based on Third-Party Data Is Better than Subjecting the Taxpayer to a Levy that Could Cause Economic Hardship.**

The National Taxpayer Advocate finds the IRS's explanation of why taxpayers with unfiled returns should not be included in the FPLP LIF unconvincing. In its response, the IRS states that it does not include taxpayers with an unfiled return in the LIF, because it would then be relying solely on third-party information without allowing a taxpayer to provide his or her own information as a basis for estimated income. However, the IRS is already relying solely on such information when deciding whether a taxpayer is eligible for the LIF. As stated in the IRS response, the IRS determines eligibility for the LIF by either the latest current-year tax return or third-party reporting information. Therefore, the IRS would merely be using the same practice for taxpayers with delinquent unfiled returns as it does for other taxpayers included in the filter.

#### **TAS Research Contained in this Most Serious Problem Is Accurate.**

In its response, the IRS questions the applicability of a TAS data review pertaining to nonfilers and the FPLP. For this Most Serious Problem, TAS looked at a representative sample of 435 cases where taxpayers had been excluded from the LIF because they had delinquent unfiled returns,<sup>49</sup> then reviewed the sample to determine what percentage of

<sup>48</sup> IRS, IR 2011-20, *IRS Announces New Effort to Help Struggling Taxpayers to Get a Fresh Start; Major Changes Made to Lien Process* (Feb. 24, 2011).

<sup>49</sup> These cases had a levy sent or levy proceeds received during October 2011 through about August 15, 2011.

these taxpayers would fall below 250 percent of the federal poverty level. TAS found that 20.7 percent were below 250 percent of the poverty level.<sup>50</sup> TAS provided the IRS with a written explanation of its methodology for this analysis on December 6, 2011, and further discussed this methodology on a conference call on December 21, 2011. Although business debts were not included in the unfiled return analysis, the National Taxpayer Advocate believes the exclusion of taxpayers with a business debt from the LIF is inconsistent with the overall purpose of the filter (*i.e.*, preventing taxpayers who fall below 250 percent of the poverty guidelines from experiencing an economic hardship).

The National Taxpayer Advocate notes that the IRS itself shows a singular lack of curiosity of how to eliminate from its work stream taxpayer cases that involve economic hardship and result in significant rework. She reminds the IRS that one of the drivers for the TAS research was that inclusion of these low income taxpayers in the FPLP not only harmed the taxpayers but also resulted in significant rework for TAS and the IRS and Low Income Taxpayer Clinics to unwind the damaging effects of the levies. The almost 27 percent reduction in TAS FPLP cases demonstrates the effectiveness of the LIF screen.<sup>51</sup> This same driver applies today to low income taxpayers who are nonfilers or who have BMF debts.

#### **The IRS Should Be Working with Taxpayers Who Are Subject to the FPLP or the LIF to Resolve Their Tax Debts.**

As noted above, TAS recommends that once the IRS identifies a case for the FPLP, it take an additional step to try to resolve the case. For instance, the IRS could be more active in reaching out to taxpayers who are either subject to the FPLP or filtered out by the LIF by sending them information regarding the offer in compromise program, and even invite the taxpayers to submit offers if they believe they qualify. Further, the National Taxpayer Advocate disagrees that the IRS needs a full Collection Information Statement to determine CNC status. Based on internal databases that can identify assets, the IRS should be able to determine how many of the taxpayers subjected to the FPLP are true hardship cases. In fact, this approach could be a better use of Collection resources than current procedures, *i.e.*, issuing levies and assigning cases to the Queue. Further, it would reduce the accounts receivable inventory. In cases where the taxpayer meets the low income criteria of the LIF, the IRS should also *actively* explore the possibility of an OIC or CNC. If the IRS believes a personal contact is necessary to make a CNC determination in these cases, it can do so as a proactive program decision. However, in these cases, the LIF has already provided the IRS with a sufficient indicator of the taxpayer's economic hardship status to curtail enforced collection actions, in accordance with the *Vinatieri* decision. The National Taxpayer Advocate believes the prudent business decision in these cases is to allow the LIF to act as a proxy for economic hardship, and make the CNC decision without the unnecessary and potentially wasteful investment of additional Collection resources.

<sup>50</sup> The sample has a confidence level of 95 percent with a margin of error (plus or minus) of about 4.7 percent.

<sup>51</sup> TAMIS (pulled Nov. 9, 2011). Since the IRS implemented the filter (from January through September 2011), TAS FPLP cases have declined by 26.6 percent compared to the same period in 2010.

**Collection on Taxpayers' Social Security Benefits Should Be Restricted.**

The National Taxpayer Advocate is concerned that the IRS is not fully considering the demographics of taxpayers who receive Social Security. These payments provide at least half of total income for about 66 percent of aged beneficiaries and comprise 90 percent or more of total income for about 35 percent of this population.<sup>52</sup> Since Social Security recipients are more vulnerable to economic hardship, the National Taxpayer Advocate believes it is appropriate to exclude a portion of all taxpayers' Social Security benefits from collection actions, including bank levies. This approach would properly reflect Congress's desire to limit collection against such benefits. A taxpayer's other assets would still be subject to collection action, and even the proposed exclusion would cover only two months of benefits. This type of exclusion would preserve Social Security benefits that many taxpayers depend on for day-to-day living expenses.

**Recommendations**

In conclusion, the National Taxpayer Advocate offers these recommendations:

1. Eliminate criteria that exclude taxpayers with unfiled returns or business debts from the LIF.
2. If a taxpayer is subject to a 15 percent FPLP levy, or has been filtered out of FPLP by the LIF, IRS employees should review the case before taking any further collection action to determine if the taxpayer is a good candidate for the streamlined OIC process or meets CNC criteria.
3. Revise levy notices to financial institutions to state that if the account holds Social Security benefits, a portion of the benefits should be exempt from the levy.

<sup>52</sup> SSA, *Fast Facts & Figures About Social Security* (Sept. 2011).

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### RESPONSIBLE OFFICIALS

Richard E. Byrd Jr., Commissioner, Wage and Investment Division  
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### DEFINITION OF PROBLEM

The IRS uses the Excess Collection File (XSF) to store remittances when a taxpayer's payment or credit has not been identified or resolved. Unidentified remittances (*i.e.*, payments where the IRS cannot determine the identity of the person or entity making the payment or the account to which it should be applied) are systemically transferred to the XSF when they remain unresolved after one year. Other transfers occur when the IRS cannot refund credits because taxpayers failed to file returns or otherwise timely claim the credits. Payments transferred to the XSF are held for an additional seven years before dropping out of the IRS's electronic system entirely.<sup>1</sup> Once it moves credits to the XSF, the IRS generally does not attempt to identify the taxpayers to apply the credits to their accounts, and the credits ultimately provide no benefit to taxpayers as payments and are not accounted for as tax receipts.<sup>2</sup> In May 2006, the XSF contained over \$3.5 billion in unapplied credits, and as of January 2010 had grown to over \$4.7 billion — a 34 percent increase over the past four years, and more than double its 1999 balance.<sup>3</sup> Moreover, taxpayers with annual income of less than 250 percent of the poverty level (*i.e.*, low income taxpayers) accounted for 60 percent of the open cases in the XSF. Almost all of the open cases are transfers of less than \$5,000.<sup>4</sup>

The Treasury Inspector General for Tax Administration (TIGTA) has estimated that more than half of the transfers to the XSF result from IRS errors.<sup>5</sup> For example, the IRS may fail

<sup>1</sup> Internal Revenue Manual (IRM) 3.17.220 (Jan. 1, 2011).

<sup>2</sup> Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2005-30-022, *Enhancing Internal Controls for the Internal Revenue Service's Excess Collection File Could Improve Case Resolution* 16 (Jan. 2005).

<sup>3</sup> TIGTA, Ref. No. 2011-30-020, *Taxpayer Payments Were Improperly Transferred to the Excess Collections File* 1 (Mar. 2, 2011); TIGTA, Ref. No. 2000-30-088, *Millions of Dollars in Internal Revenue Service Excess Collections Accounts Could Be Credited to Taxpayers* 2 (June 2000).

<sup>4</sup> Only 1,411 (1,351+35+25) out of 41,919 transfers (three percent) were for more than \$5,000. Open cases refer to credits transferred to the XSF within the last three years.

<sup>5</sup> TIGTA, Ref. No. 2005-30-022, *Enhancing Internal Controls for the Internal Revenue Service's Excess Collection File Could Improve Case Resolution* 3 (Jan. 2005).

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to release a levy on a taxpayer's wages after the assessment identified in the levy is paid in full, and offset the surplus levy proceeds to another liability.<sup>6</sup> Because the taxpayer may have no idea this occurred, he or she may not contest the other liability or request a refund of the surplus levy amounts applied to the other liability before the statutory period for doing so expires (*i.e.*, prior to the Refund Statute Expiration Date or RSED). Moreover, IRS studies have shown that even minimal efforts to research taxpayers' whereabouts and contact them personally could prevent many of the transfers. The IRS requires such additional effort in some cases.<sup>7</sup> However, it reserves these procedures for "high-dollar" cases (in which the credit is \$100,000 or more) even though more than half of the transfers to the XSF for which a taxpayer identification number was found came from low income taxpayers and almost all are for less than \$5,000, and even though the IRS is aware that it would be cost-effective to extend the enhanced procedures to all accounts.<sup>8</sup>

Despite being the subject of a prior analysis in the National Taxpayer Advocate's Annual Report to Congress, four TIGTA audits, two IRS task forces, and multiple recommendations since 1999, the administration of the XSF remains a struggle for the IRS.<sup>9</sup> Improper transfers to the XSF, coupled with the IRS's inability to timely address and resolve these payments and their underlying issues, unduly burden taxpayers and generate costly rework for the IRS.

<sup>6</sup> IRM 5.11.5.5(2) (Sept. 14, 2010) ("Surplus levy proceeds are an offset under IRC 6402(a) and therefore levy proceeds received, in excess of the periods covered by the levy, may be applied to liabilities not listed on the levy." If liabilities not covered by the original levy remain outstanding, the IRS must "release the original levy and prepare and issue a new notice of levy to the levy source for the remaining liabilities." These procedures are not always followed. See National Taxpayer Advocate 2006 Annual Report to Congress 161-162. If the taxpayer failed to file a timely return, the IRS may have made a return, referred to as a substitute for return (SFR), as authorized by Internal Revenue Code (IRC) § 6020(b), based on information reported to the IRS. The SFR may reflect income reported by third parties, but allow only the standard deduction, one exemption, and a filing status of single or married filing separately. See IRM 4.12.1.25.3 (Oct. 5, 2010); IRM 4.12.1.24.12 (Oct. 5, 2010). See also *Allowable Expenses in an SFR*, available at <http://mysbse.web.irs.gov/reflibrary/kts/supparticles/14979.aspx>. Surplus levy proceeds may be applied to liabilities assessed pursuant to an SFR. If the taxpayer files a return claiming and substantiating additional deductions so that the tax is less than that shown on the SFR, the IRS may abate some of the tax assessed pursuant to the SFR.

<sup>7</sup> IRS, *Excess Collection Task Group Report 7*, 8 (Mar. 6, 2006).

<sup>8</sup> TIGTA, Ref. No. 2005-30-022, *Enhancing Internal Controls for the Internal Revenue Service's Excess Collection File Could Improve Case Resolution* 8 (Jan. 2005); IRS, *Report on Excess Collections Most Serious Problem Identified in 2006 National Taxpayer Advocate Report to Congress* 2, 4 (Apr. 22, 2009), on file with TAS. See, e.g., IRM 21.5.8.1(9) (Oct. 1, 2009).

<sup>9</sup> National Taxpayer Advocate 2006 Annual Report to Congress 171; TIGTA, Ref. No. 2011-30-020, *Taxpayer Payments Were Improperly Transferred to the Excess Collection File* (Mar. 2, 2011); TIGTA, Ref. No. 2005-30-022, *Enhancing Internal Controls for the Internal Revenue Service's Excess Collection File Could Improve Case Resolution* (Jan. 2005); TIGTA, Ref. No. 2001-30-124, *Increased Oversight Is Needed to Ensure Taxpayers Receive Credit for Millions of Dollars in Excess Collections Accounts* (July 2001); TIGTA, Ref. No. 2000-30-088, *Millions of Dollars in Internal Revenue Service Excess Collections Accounts Could Be Credited to Taxpayers* (June 2000); IRS, *Excess Collection Task Group Report 7*, 8 (Mar. 6, 2006).

## ANALYSIS OF PROBLEM

### Background

The IRS uses the XSF to store two types of credits: 1) unidentified remittances more than a year old, and 2) credit balances in taxpayers' accounts for which the taxpayers have not requested a refund before the RSED expires.<sup>10</sup>

Accounting for the first type of XSF transfer (unidentified remittances) begins when the IRS receives a payment from or on behalf of a taxpayer, deposits it, and attempts to apply the credit to the taxpayer's account. If the IRS cannot determine the appropriate account, it credits the payment to the Unidentified Remittances File (URF), where employees work to identify and resolve the credit issue. If the account remains unidentified after a year, the IRS transfers the payment from the URF to XSF Account 6800. The second type of XSF transfer (an expired RSED) arises when amounts credited to a taxpayer's account exceed the taxpayer's liability. When the period for claiming a credit or refund expires without the taxpayer filing a return or otherwise claiming the credit, the IRS likewise transfers these statute-expired credits to XSF Account 6800. The IRS does this systematically on a weekly basis, and handles it manually when an employee determines the transfer is required.<sup>11</sup>

At the end of each fiscal year, the IRS transfers the balance in XSF Account 6800 to XSF Account 9999, where the credits are accessible using the Integrated Data Retrieval System (IDRS) for seven years.<sup>12</sup> However, once the IRS completes the move to Account 9999, it generally no longer attempts to identify and contact taxpayers to resolve the credits. Moreover, IRS employees may not realize during a routine review of a taxpayer's accounts (*e.g.*, when a taxpayer calls customer service for information or assistance) that a transfer has occurred. This information will emerge only if the employee happens to review the specific tax module containing a detailed record of the transfer, enabling the employee to inform the taxpayer of the transfer and help determine if the taxpayer can recover the

<sup>10</sup> Generally, taxpayers must request a refund within three years from the date their return was filed, or two years from the time the tax was paid, whichever occurs later, or, if no return was filed, within two years from the time the tax was paid. IRC § 6511(a). If taxpayers meet the three-year requirement, they can recover payments made during the three years preceding the date of the refund claim, plus any extension period for filing the return. However, taxpayers who do not meet the three-year requirement can recover only payments made during the two years preceding the date of the refund claim. IRC § 6511(b)(2).

<sup>11</sup> For example, a taxpayer may file a return showing a balance due or no tax due, after amounts withheld from income, estimated tax payments, or various tax credits are taken into account. Because the account does not have a credit balance, it will not systemically shift to XSF. However, if the taxpayer files an amended return more than three years after the original return was filed and the amended return causes a credit balance in the account, the taxpayer cannot recover any of the tax already paid through withholding, estimated tax payments, or claimed credits, and an IRS employee properly transfers the excess to the XSF.

<sup>12</sup> The IRS uses IDRS to manage taxpayer accounts in its system of databases.

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funds before the RSED lapses.<sup>13</sup> After seven years, the IRS transfers unresolved payments from XSF Account 9999 to a paper file (“XSF 50 Dropped Listing”).<sup>14</sup>

TAS requested information about the characteristics of the XSF account that was not forthcoming from the IRS. Some information, such as the amount in XSF that resulted from levies that were not released when the accounts were fully paid, and the type of levy, was not obtainable because the IRS does not record it. Other information, such as a breakdown of the amounts each operating division transfers to the XSF account, stratification of amounts in the account by \$5,000 increments, and breakouts of the amounts in the account by source, could be obtained, but would require the operating division to submit a Uniform Work Request (UWR).<sup>15</sup> The IRS responded, “At this time, a current UWR will not be requested due to budgetary issues.”<sup>16</sup> The National Taxpayer Advocate finds it astonishing that the IRS will not conduct research where there is clear evidence of harm to taxpayers or to improve programs and reduce taxpayer and IRS burden, when doing so requires a Uniform Work Request. The administration of the XSF is an ongoing problem, and the IRS needs to submit this Uniform Work Request. TAS is more than willing to assist the IRS in any way to develop it.

While nearly all IRS functions can request transfers, the Wage and Investment division (W&I) controls and monitors the administration of the XSF account.<sup>17</sup> The chart below shows the change in the balance of the XSF from fiscal year (FY) 2004 through FY 2010.

<sup>13</sup> An IRS employee responding to a taxpayer telephone inquiry typically uses IDRS command codes (e.g., ENMOD, INOLE, SUMRY, or IMFOL) that generate a computer screen with a “snapshot” of the taxpayer’s account for all tax years. These snapshots do not indicate that an XSF transfer has been made. Only if the employee accesses specific tax modules (i.e., the IRS record for specific tax years) will the XSF transfer appear. For example, the IRS is required to post an XSF indicator (using TC 971 Action Code 296) to the tax module containing the credit at the time of the transfer. IRM 3.17.220.2.2.1.2(2)(b) (Jan. 1, 2011). This signifies that employees have completed the required research to contact a taxpayer, and averts duplication of effort in researching the account in the future. However, the IRS is required to document that these procedures were followed only for transfers of \$100,000 or more. IRM 21.5.8.1(9) (Oct. 1, 2009).

<sup>14</sup> See email responses from W&I XSF subject matter expert (June 8 and 23, 2011) on file with TAS. IRM Exhibit 1.15.29-1 (July 1, 2005) provides that the underlying XSF source documents are maintained, and the payments can be recovered for 30 years. “Once it has been established that a credit can be re-applied, to re-add the credit to the file and re-apply it to the taxpayer’s account can be completed within days.” Unapplied payments otherwise remain in XSF (Account 9999) indefinitely; they are not accessible using IDRS after seven years and are never accounted for as tax receipts. IRM 3.17.220.2 (Jan. 1, 2011); IRM 3.17.63.15.48 (Jan. 1, 2011); IRM 3.8.44.2 (Jan. 1, 2011); IRM 1.15.29-1 282, Job No. NC1-58-82-9, Item 162 (Oct. 1, 2010); IRM 3.17.220.1.8 (Jan. 1, 2011).

<sup>15</sup> IRS response to TAS information request (July 14, 2011). Examples of sources of transfers include amounts that resulted from withholding credits, advanced earned income tax credit, payments with the return, subsequent payments, advance payments on a deficiency, and estimated tax payments (specifically the USDA Discrimination Settlement Payments, a.k.a. Pigford payments).

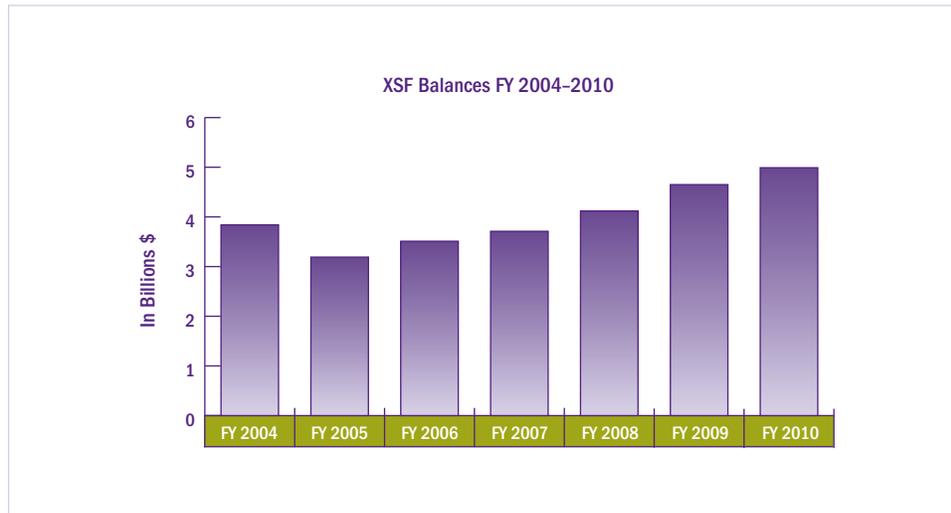
<sup>16</sup> IRS response to TAS information request (July 14, 2011).

<sup>17</sup> IRM 3.17.220.1 (Jan. 1, 2011); IRM 2.3.45.1 (Jan. 1, 2003).

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**FIGURE 1.19.1, Growth in the Excess Collection File (FY 2004–FY 2010)<sup>18</sup>**



The 2010 balance of almost five billion dollars is the result of steady increases of between five and 13 percent each year for each of the past five years.

Table 1.19.2 below reflects the composition of the XSF account as of October 2003, in terms of tax modules and dollars, based on data obtained by TIGTA.<sup>19</sup>

**TABLE 1.19.2, Dollars by Tax Module in the XSF as of October 2003**

| Tax Module Ranges <sup>20</sup> | Modules      | Dollars <sup>21</sup>   |
|---------------------------------|--------------|-------------------------|
| \$25,000 - \$49,999             | 5,109        | \$ 173,517,277          |
| \$50,000 - \$99,999             | 2,080        | \$ 140,909,261          |
| \$100,000 - \$249,999           | 1,006        | \$ 148,385,202          |
| \$250,000 - \$499,999           | 302          | \$ 104,902,076          |
| \$500,000 - \$999,999           | 118          | \$ 79,353,674           |
| \$1,000,000 and over            | 96           | \$ 1,019,593,411        |
| <b>Total</b>                    | <b>8,711</b> | <b>\$ 1,666,660,901</b> |

Source: Data extract obtained by TIGTA as of October 2003.

<sup>18</sup> Based on URF 60 (XSF) File Analysis Reports (Accounts 6800 and 9999) FY 2004 through FY 2010, IRS response to TAS information request (July 14, 2011). TAS requested data from 2001 to parallel the years described in TIGTA reports, but the IRS responded that it cannot provide data earlier than FY 2004 without a Uniform Work Request.

<sup>19</sup> TIGTA, Ref. No. 2005-30-022, *Enhancing Internal Controls for the Internal Revenue Service's Excess Collection File Could Improve Case Resolution 8* (Jan. 2005).

<sup>20</sup> The designation "Tax Module Ranges" refers to the amounts of credits transferred in a specific tax year.

<sup>21</sup> All figures are rounded. TIGTA did not report on tax modules of less than \$25,000.

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As Table 1.19.2 shows, most tax *modules* with credits transferred to XSF were in the \$25,000-\$49,999 range, and if we leave aside cases involving credits of one million dollars or more, these “small dollar” cases represented the single greatest category of *dollars* transferred to the XSF.

The IRS is unable to show amounts in the XSF account broken down into \$5,000 increments, but it did provide data about “open” XSF cases (*i.e.*, credits transferred to XSF within the last three years). If these credits were erroneously transferred before the RSED expired, the IRS might be able to refund them to taxpayers.<sup>22</sup> Open cases account for about one percent of the total credits in XSF.<sup>23</sup> An analysis of open cases shows that the lower the amount transferred to the XSF, the more often the taxpayer is low income. Moreover, the data shows that almost all transfers are of “*small-dollar*” amounts, and suggests that *more than half* are associated with *low income taxpayers*, as shown in the following table.

**TABLE 1.19.3, Credits in XSF That Were Transferred From 2007-2010 From Low Income Taxpayers<sup>24</sup>**

| Credits Range         | Income of 250% of Poverty Threshold or Less |               |              |
|-----------------------|---|---------------|--------------|
|                       | Total                                       | Count         | % of Total   |
| \$0 to \$250          | 20,588                                      | 13,476        | 65.46        |
| \$251 to \$500        | 7,247                                       | 4,738         | 65.36        |
| \$501 to \$750        | 3,298                                       | 1,949         | 59.10        |
| \$751 to \$1,000      | 2,309                                       | 1,329         | 57.56        |
| \$1,001 to \$2,000    | 4,081                                       | 2,094         | 51.31        |
| \$2,001 to \$3,000    | 1,713                                       | 843           | 49.21        |
| \$3,001 to \$4,000    | 730   | 280           | 38.36        |
| \$4,001 to \$5,000    | 542   | 211           | 38.93        |
| \$5,001 to \$50,000   | 1,351                                       | 369           | 27.31        |
| \$50,001 to \$100,000 | 35  | 9             | 25.71        |
| Over \$100,000        | 25  | 10            | 40.00        |
| <b>Total</b>          | <b>41,919</b>                               | <b>25,308</b> | <b>60.37</b> |

Source: IRS URF4501 Part 3 Reports FY 2007-2010, Account Receivable XSF/Open Report for Month Ending 9/30.

<sup>22</sup> See IRM 3.17.220.2.15 (Jan. 1, 2011). In 2005, TIGTA reported that 65 percent of the transfers in cases it reviewed resulted from employee errors that could have been avoided with increased managerial oversight, additional account research, and taxpayer contact. In an earlier audit, TIGTA reported that the number of XSF cases with outstanding liabilities was nearly equally divided between erroneous adjustments and transfers that were made because taxpayers failed to file returns or request a refund before the RSED expired. TIGTA, Ref. No. 2005-30-022, *Enhancing Internal Controls for the Internal Revenue Service's Excess Collection File Could Improve Case Resolution 1* (Jan. 2005); TIGTA, Ref. No. 2000-30-088, *Millions of Dollars in Internal Revenue Service Excess Collections Accounts Could Be Credited to Taxpayers 3, 4* (June 2000).

<sup>23</sup> Conference calls with IRS XSF Subject Matter Experts (Aug. 30, 2011, and Sept. 28, 2011).

<sup>24</sup> TAS Research. The table describes the 41,919 open cases in the URF4501 Part 3 Report from 2007 to 2010 for which TAS was able to determine the amount of the taxpayer's total positive income from a filed Form 1040. TAS was able to determine the income of a taxpayer with an open case, where the taxpayer identification number is identified, about 52 percent of the time. The count column identifies taxpayers whose total positive income was less than or equal to 250 percent of the U.S. weighted average poverty threshold by family size, by year of their income. Total positive income (TPI) is the sum of Non-Business TPI, Business Income (positive Schedule C amounts), and Farm Income (positive Schedule F amounts). Only total positive values from the income fields listed are used. Income fields are (a) Wages, (b) Interest, (c) Dividends, (d) Other Income, (e) Distributions, (f) Schedule-C Net Profits, (g) Schedule-F Net Profits. Losses are treated as a zero.

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The Department of Health and Human Services issues annual poverty guidelines that are used to determine financial eligibility for certain federal programs, including the low income taxpayer clinic (LITC) program.<sup>25</sup> According to IRC § 7526(b)(1)(B), taxpayers with income of less than 250 percent of the poverty level (*i.e.*, less than \$27,075 in 2009) were low income taxpayers for purposes of qualifying for LITC assistance. Table 1.19.3 (above) shows that taxpayers with annual income of less than 250 percent of the poverty level (*i.e.*, low income taxpayers) accounted for 60 percent of the open cases in the XSF. Almost all of the open cases are transfers of less than \$5,000.<sup>26</sup>

**Personal Contact with Taxpayers Prevents Transfers to the XSF, but the IRS Reserves Enhanced Procedures for Locating and Contacting Taxpayers for High-Dollar Cases.**

In January 2004, the IRS commissioned the Excess Collection Task Group (XSFTG) to evaluate TIGTA's findings. In 2006, the group reported that early intervention with non-filers could be key to reducing return-filing delinquencies and transfers to the XSF.<sup>27</sup> The report also described an earlier IRS study involving large-dollar cases (where the credit was \$100,000 or more) which revealed that where the IRS takes minimal research steps, it locates taxpayers, brings them into filing compliance, and resolves payments that otherwise would be destined for the XSF.<sup>28</sup> In 2006, the National Taxpayer Advocate recommended the IRS extend the same treatment to small-dollar cases, noting:

From a taxpayer-focused point of view, the need for a \$1,000 refund to a low or middle income taxpayer is as great as (and possibly even greater than) a refund of \$100,000 for a Fortune 500 company. Accordingly, we believe the IRS should provide this same service to all taxpayers, regardless of the dollar amount.<sup>29</sup>

In response, the IRS conducted a study and in 2009 found the results “warrant a recommendation that the large dollar process be expanded for all credit balance accounts.” The study found that no additional staffing would be required to work smaller-dollar accounts nationwide and that applying the credit rather than transferring it to XSF meant expending fewer resources on subsequent notices and staff time.<sup>30</sup> For taxpayers, personal contact resulting from enhanced research could mean another chance to become compliant and fewer dollars lost to expiring RSEDs. Especially in view of TAS's analysis showing that

<sup>25</sup> See Dept. of Health and Human Services, Annual Update of the Poverty Guidelines, 73 Fed. Reg. 4199 (Jan. 23, 2009), available at <http://aspe.hhs.gov/poverty/09fedreg.shtml>. For example, under the guidelines, the 2009 poverty level for a single person was \$10,830.

<sup>26</sup> Only 1,411 (1,351+35+25) out of 41,919 transfers (three percent) were for more than \$5,000.

<sup>27</sup> IRS, *Excess Collection Task Group Report 2*, 7 (Mar. 6, 2006).

<sup>28</sup> *Id.* at 7, 8 (Mar. 6, 2006). The 2005 TIGTA report had arrived at the same conclusion. TIGTA, Ref. No. 2005-30-022, *Enhancing Internal Controls for the Internal Revenue Service's Excess Collection File could Improve Case Resolution* 3, 5, 6 (Jan. 2005).

<sup>29</sup> National Taxpayer Advocate 2006 Annual Report to Congress 166. The IRS initially rejected this recommendation, citing preliminary results from a sample study pointing to a decrease in employee productivity and less favorable results than experienced with large-dollar cases. Joint Audit Management Enterprise System (JAMES), 2006 Annual Report to Congress Scorecard.

<sup>30</sup> IRS, *Report on Excess Collections Most Serious Problem Identified in 2006 National Taxpayer Advocate Report to Congress 2*, 4 (Apr. 22, 2009), on file with TAS.

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open XSF cases are likely to involve a small-dollar transfer from a low income taxpayer, the IRS should implement its own recommendation.

### **IRS Guidance and Oversight Are Insufficient for Handling XSF Transactions.**

In 2001, IRS managers told TIGTA that employees were not trained to apply credits properly to a taxpayer's account and that the IRS had not established performance measures or program goals to monitor XSF activity.<sup>31</sup> In the 2006 Annual Report to Congress, the National Taxpayer Advocate discussed the lack of clarity regarding the research procedures required to verify that an RSED had expired prior to transferring credits to the XSF.<sup>32</sup> The research procedures range from requiring virtually no research to requiring verification that the refund period has expired to simply noting that detailed analysis "may be required" and that "[i]f the taxpayer has been injured because of IRS action or failure to act, his/her rights may be restored."<sup>33</sup> Despite concerns the National Taxpayer Advocate raised five years ago, the IRS has yet to clarify its conflicting instructions or establish written XSF procedures for its Criminal Investigation function, as it committed to do by August 1, 2007, in its formal response to the 2006 Annual Report.<sup>34</sup>

Even where a taxpayer makes a claim for a refund (which should prevent a transfer to the XSF account), a transfer may nonetheless occur if the claim is informal and IRS employees do not recognize its validity. The IRS's Office of Chief Counsel advises that a taxpayer's attempts to dispute the underlying invalid assessment, coupled with the IRS's record of the dispute, constitute a valid informal claim.<sup>35</sup> The IRS could reduce the number of improper transfers to the XSF by training employees to recognize, develop, and resolve the underlying issues in XSF cases, such as RSED determinations, and to recognize and handle informal claims.

## **CONCLUSION**

Despite numerous recommendations from TAS and TIGTA over the past 11 years, as well as the IRS's own efforts to reduce the balance in the XSF account, the fund continues to grow. Oversight and proper application of taxpayer payments and credits is a fiduciary trust that

<sup>31</sup> TIGTA, Ref. No. 2001-30-124, *Increased Oversight Is Needed to Ensure Taxpayers Receive Credit for Millions of Dollars in Excess Collections Accounts* 5 (July 2001).

<sup>32</sup> National Taxpayer Advocate 2006 Annual Report to Congress 164, 547-548.

<sup>33</sup> Compare IRM 3.17.220.1.5(2) (Jan. 1, 2011) with IRM 3.17.220.2.2(4)-(6) (Jan. 1, 2011) and IRM 3.17.220.2.7.1.1.1(1) (Jan. 1, 2011).

<sup>34</sup> JAMES, 2006 Annual Report to Congress Report Card; IRS response to TAS information request (July 21, 2011).

<sup>35</sup> IRS, Office of Chief Counsel Memorandum, POSTF-129756-10 (Aug. 19, 2010) (current IRS procedure is to allow a refund if a written product created by IRS personnel sufficiently details an oral claim for refund); IRM 4.90.7.2 (June 30, 2007); IRM 25.6.1.10.2.6.3 (Oct. 1, 2007). A formal claim is a request for refund that identifies the tax years and provides sufficient detail to establish the basis for the claim. Taxpayers would typically use IRS Forms 843, 1040X, or 1120X to make a formal claim of refund that was not claimed on an original return. An informal claim is a request that does not meet all of the statutory requirements of a formal claim, but is perfected at a later date. See *U.S. v. Kales*, 314 U.S. 186 (1941); *Newton v. U.S.*, 163 F. Supp. 614 Ct. Cl. (1958). Claims for refund must be in writing. However, the Court of Federal Claims has held that a contemporaneous writing created by IRS personnel from a taxpayer's oral statements may satisfy the written component of the claim. See *New England Elec. System v. U.S.*, 32 Fed. Cl. 636 (1995). Current IRS policy is that whenever a claim provides the necessary information, whether formal or informal, it is handled as a valid claim for refund. IRS, Office of Chief Counsel Memorandum, POSTF-129756-10 (Aug. 19, 2010).

the IRS should take seriously. The IRS's inability to resolve credits in a timely fashion creates unnecessary taxpayer burden, impedes taxpayers from obtaining their rightful refunds, and ultimately can erode taxpayers' confidence in the system. The problem is amplified by the IRS's policy of only employing enhanced research procedures to resolve high-dollar transfers, because most transfers are for less than \$5,000 and more than half are associated with low income taxpayers. The National Taxpayer Advocate offers these preliminary recommendations for improving the XSF:

1. Require use of the same enhanced procedures to locate and contact taxpayers currently in place for large-dollar credits for all accounts destined for transfer to the XSF.
2. Clarify IRM requirements for researching statute-expired credits and handling informal claims.
3. Develop additional guidance to prevent overpayments resulting from a levy from causing transfers to the XSF.
4. Train employees to determine RSEDs accurately and to recognize and properly handle informal claims.
5. Establish performance goals and measures for the overall XSF process and require each affected operating division to report on its own specific XSF activities, including the dollar amount it transferred to XSF, in each of its quarterly Business Performance Reports.
6. Implement and publish XSF procedures for the Criminal Investigation function.
7. Establish an XSF indicator on the entity module that will appear in response to general IDRS command codes (*e.g.*, ENMOD, INOLE, SUMRY, or IMFOL) to alert employees to the amounts and years of XSF transfers without having to access specific tax modules, and train employees to discuss XSF transfers with taxpayers.

## IRS COMMENTS

The IRS developed the IRS Excess Collection File to contain receipts that cannot be identified or applied. Two general ledger accounts, 6800 and 9999, were established to separate these files from the receipts that can be identified and applied to the appropriate accounts. Account 6800 is used for credits initially transferred to the XSF. This file rolls up into Account 9999, Revenue Clearance Accountability, at fiscal year end. Any unapplied credits will remain in the XSF file for up to seven years from the received date of the payment/credit. The IRS does not use the income level of taxpayers to determine what funds are transferred into XSF.

There are several situations that result in a transfer of credits to the XSF. The more common reasons include:

- Unidentified Remittances, which are payments where the IRS is unable to determine the appropriate account to which the payment applies that are under one year old.

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- Expiration of the refund or assessment statute of limitations, which then precludes the IRS from applying or refunding any payments made on a taxpayer account.
- Payment or credit for which there is no return filed or the IRS is unable to locate or secure a return within the Statute of Limitations (for refunds).

There are also instances, such as bankruptcy or a wrongful levy, when the credit cannot legally be applied. These credits must be placed in the XSF. In addition, credits related to cases in which the Refund Statute Expiration Date or Assessment Statute Expiration Date has expired are placed in the XSF. If the credit is placed in the XSF file for legal reasons, no further action is taken.

The IRS has developed and made improvements to the system of controls to ensure taxpayer's payments and credits are identified and properly applied. This includes generating transcripts for certain freeze conditions and sending notices to the taxpayer as a follow up. Further, in response to recommendations by TAS and TIGTA, the IRS has established procedures that require additional taxpayer contact and managerial oversight, and apply XSF account indicators for identification. The IRS also assembled a task force for further review. Additional training has been provided to employees and IRM provisions have been revised to clarify instructions and documentation requirements.

- IRM 3.17.220, *Excess Collections File*
- IRM 25.6.1, *Statute of Limitations Processes and Procedures*
- IRM 21.2.4, *Master File Accounts Maintenance*

After the first year, open XSF cases are assigned to a tax examiner and worked for resolution. A listing of unresolved "open" cases is generated and worked every six months by researching for new or additional information available for follow up with the taxpayer. If the payment or credit continues to be unidentified or the taxpayer does not claim the credit, it remains in XSF. Whenever a payment or credit can be reapplied to the taxpayer's account, the originator notifies XSF personnel who will reapply the amount to the taxpayer's account.

We will consider opportunities to enhance our processes in this area. Comments on the preliminary recommendations are below.

The IRS agrees to conduct a study of the XSF file open cases that have smaller dollar credits to determine if the enhanced procedures and additional research needed to locate and contact taxpayers proves to be beneficial and cost effective. The study will include a process for differentiating and quantifying valid credits from invalid credits. Invalid credits would include unsubstantiated credits transferred to the XSF as a result of pre-refund intervention processes. Based on the findings the IRS will consider implementation of additional efforts on these cases.

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The IRS agrees with clarifying IRM requirements in this area. We plan to review the following IRMs and identify any areas where clarification is necessary and take action to rewrite the provisions:

- IRM 3.17.220, *Excess Collections File*
- IRM 21.2.4, *Master File Accounts Maintenance*
- IRM 21.5.3.2, *What are Claims for Credit, Refund, and Abatement?*
- IRM 25.6.1, *Statute of Limitations Processes and Procedures*
- IRM 25.6.1.7.2, *Time When Payments and Credits are Considered to be Made*
- IRM 25.6.1.10.2.6.3, *Informal Claims*

The IRS questions whether additional guidance regarding the offset of levy proceeds is necessary. Under IRC § 6402(a), levy proceeds received in excess may be applied to liabilities not listed on the levy. Once the levy proceeds post to the account paying the account in full, the excess will be refunded unless someone places a hold on the account or the excess proceeds are offset to another account that is cross-referenced to the taxpayer.

With respect to training, the IRS continually seeks opportunities to improve training and we will take steps in this area. Course 34002, *Statute Awareness*, includes a lesson for determining the RSED and is mandatory for Accounts Management Continuing Professional Education in 2012. Course 34002, *Statute Awareness Lesson 2, Refund Statute Expiration Date (RSED)*, contains examples and procedures for determining the RSED accurately. The IRS anticipates including a lesson for addressing and properly handling informal claims in FY2013.

Subject to available data and resources, we will consider the development of specific reports by business division that could be used to ensure upstream processes are functioning properly so credits are correctly sent to the XSF.

Regarding the recommendation to publish procedures for the Criminal Investigation function, a reorganization occurred in 2009 moving the CI function, which performed account adjustment work on individual returns, to the Wage & Investment organization. That operation is now under the Accounts Management Taxpayer Assurance Program (AMTAP), which follows procedures in IRM 3.17.220.2.2 for transferring credits to the XSF. As stated above, we will review IRM 3.17.220 to determine if additional clarification is needed.

We will consider the recommendation to establish an XSF indicator on the entity module in the future that would assist the customer service representative in providing the correct information to the taxpayer on a credit that may no longer be available to them. Note that this would necessitate an extensive system change that would require prioritization based on capacity issues and the availability of resources.

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## Taxpayer Advocate Service Comments

The National Taxpayer Advocate commends the IRS for its commitment to improve its administration of the XSF. We are encouraged by plans to train employees to make accurate RSED determinations (slated for delivery in FY 2012), and to develop new training that will equip employees to protect taxpayers by identifying and properly handling informal claims for refund (slated for development in FY 2013). We ask that the IRS share both of these trainings with TAS in advance so that we may make suggestions for improvement, where warranted.

We are pleased that the IRS agrees it needs greater clarity in existing IRM guidance, and that it will consider developing performance reports for each operating division to monitor XSF activity. We are also pleased that the IRS will consider requiring an XSF indicator on the entity module, which will enable customer service representatives to inform taxpayers of expiring RSEDs, guide them in submitting claims for refund, and prevent payments and credits from being lost. Despite the reprogramming this change may require, it will save significant IRS rework and prevent serious harm to taxpayers, and should be undertaken as soon as possible—we are holding the taxpayer's money, after all.

In addressing the National Taxpayer Advocate's concern that the IRS makes disproportionately little effort to prevent transfers from low income taxpayers, the IRS points out that it does not base decisions to transfer credits on the amount of income. The National Taxpayer Advocate does not believe that the IRS singles out low income taxpayers for transfer of credits to XSF. However, transferring a credit belonging to a low income taxpayer to the XSF has a disproportionate economic impact compared to transferring the same amount belonging to a higher-income taxpayer. We welcome the IRS's commitment to include, in a study of small-dollar cases, a process for differentiating and quantifying valid credits from invalid ones. However, we would reiterate that in 2009, the IRS's own experts recommended expanding the procedures to locate and contact taxpayers in large-dollar cases to low-dollar cases as well, finding that no additional IRS resources would be needed.<sup>36</sup> Accordingly, the National Taxpayer Advocate urges the IRS to implement the recommendation of its experts without delay.

The IRS questions whether it needs additional guidance regarding the offset of levy proceeds, noting, "levy proceeds received in excess may be applied to liabilities not listed on the levy."<sup>37</sup> However, the IRS fails to mention its statutory obligation to release levies promptly,<sup>38</sup> and as the National Taxpayer Advocate noted in her 2006 Annual Report to Congress:

<sup>36</sup> IRS, *Report on Excess Collections Most Serious Problem Identified in 2006 National Taxpayer Advocate Report to Congress* 2, 4 (Apr. 22, 2009), on file with TAS.

<sup>37</sup> IRC § 6342(b) provides that "any surplus proceeds...shall...be credited or refunded...to the person or persons legally entitled thereto."

<sup>38</sup> IRC § 6343(a)(1)(A) requires the IRS to release a levy "the liability for which such levy was made is satisfied."

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TAS has identified situations where the IRS did not follow its published guidance and continued to offset overpayments against liabilities without issuing additional levies. These offsets were not one-time occurrences but were situations where the IRS applied levy payments for two to three years or longer. In many cases, the taxpayer may not have been notified of the application since current procedures require no personal contact or correspondence. The application of such payments to a module not listed on the original levy is of particular concern to the National Taxpayer Advocate because the taxpayer may not have received a CDP notice or other recent notice for this additional collection activity.<sup>39</sup>

TAS recently witnessed the harm the IRS can cause when it fails to release a levy promptly (i.e., after the liabilities subject to the levy have been fully paid), applies excess levy proceeds to a liability not listed on the levy, and then transfers the funds to the XSF. If the IRS applies excess levy proceeds to a liability assessed under its substitute for return (SFR) authority without fulfilling its statutory requirement to notify the taxpayer of the offset, the taxpayer may not be aware of the account activity for the SFR year. The taxpayer may later file a delinquent return showing a lesser tax liability than the SFR assessment, which the IRS may accept and reduce the liability. The taxpayer will not be able to recover any of the overpayments resulting from the offset if the statutory period for requesting a refund has expired. The IRS would be required to transfer the funds, which the taxpayer did not owe, and which the IRS should never have collected, to the XSF. Additional guidance that alerts employees to this possibility could help prevent this unnecessary burden on taxpayers.

In 2007, the IRS agreed to establish written XSF procedures for its Criminal Investigation function by August 1, 2007.<sup>40</sup> The IRS points out that in 2009 it merged the criminal investigation adjustment work on individual returns into the Accounts Management Taxpayer Assurance Program, which adheres to the XSF transfer procedures in IRM 3.17.220.2.2. TAS reviewed the IRM, including IRM 3.17.220.2.2, but found no reference to the reorganization, no AMTAP procedures, and no source code for tracking criminal investigation XSF activity. The IRS indicates that it plans to review the IRM to determine if it needs further clarification.

<sup>39</sup> National Taxpayer Advocate 2006 Annual Report to Congress 121. Moreover, TAS identified instances in which the IRS transferred excess levy proceeds directly to the XSF rather than refunding them to the taxpayers. *Id.* at 161-162.

<sup>40</sup> JAMES, 2006 Annual Report to Congress Report Card; IRS response to TAS information request (July 21, 2011).

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## Recommendations

To improve the administration of the XSF, the National Taxpayer Advocate recommends that the IRS:

1. Require use of the same enhanced procedures to locate and contact taxpayers currently in place for large-dollar credits for all accounts destined for transfer to the XSF.
2. Develop additional guidance to prevent overpayments resulting from a levy from causing transfers to the XSF.
3. Establish performance goals and measures for the overall XSF process.
4. Require each affected operating division to report on its own specific XSF activities, including the dollar amount it transferred to XSF, in each of its quarterly Business Performance Reports.
5. Implement and publish XSF procedures for criminal investigation work, whether carried out by the CI function or by another IRS function.
6. Establish an XSF indicator on the entity module that will appear in response to general IDRS command codes (*e.g.*, ENMOD, INOLE, SUMRY, or IMFOL) to alert employees to the amounts and years of XSF transfers without having to access specific tax modules.
7. Train employees to discuss XSF transfers with taxpayers.

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

Steven T. Miller, Deputy Commissioner, Services and Enforcement  
 Faris Fink, Commissioner, Small Business/Self-Employed Division  
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 Joseph H. Grant, Acting Commissioner, Tax Exempt and Government Entities Division  
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 Victor S.O. Song, Chief, Criminal Investigation  
 William J. Wilkins, Chief Counsel  
 Rosemary Marcuss, Director, Office of Research, Analysis, and Statistics

**DEFINITION OF PROBLEM**

The IRS is required by the Freedom of Information Act (FOIA) to disclose all “instructions to staff that affect a member of the public,” unless an exemption applies.<sup>1</sup> It does not always consistently and timely do so.<sup>2</sup> This deprives taxpayers and their representatives of information that could help them prevent or resolve tax problems and disputes; leaves them uncertain about whether they can rely on information from IRS employees; increases the risk 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.

When the IRS fails to make guidance available to the public, it often fails to vet (or “clear”) the guidance as well. While we understand the IRS often needs to proceed quickly, such shortcuts can result in ill-advised guidance and procedures that, in some cases, violate the law. The primary problems are that the IRS:

- Sometimes establishes or changes procedures by issuing memos or using an internal system called SERP (the Servicewide Electronic Research Program) without making the new or updated procedures available to the public;<sup>3</sup>

<sup>1</sup> See generally 5 U.S.C. § 552.

<sup>2</sup> For a discussion of IRS transparency, see National Taxpayer Advocate 2006 Annual Report to Congress 10-30 (Most Serious Problem: *Transparency of the IRS*); National Taxpayer Advocate 2008 Objectives Report to Congress xxi-xxvii (*Update on Transparency of the IRS*); and National Taxpayer Advocate 2010 Annual Report to Congress 71-84 (Most Serious Problem: *IRS Policy Implementation Through Systems Programming Lacks Transparency and Precludes Adequate Review*). As discussed below, the IRS has made significant improvements since our last report.

<sup>3</sup> These documents may include “interim guidance memos” (IGMs) or “interim procedural updates” (IPUs), as discussed below.

- Sometimes changes procedures without writing them down or by issuing SERP “alerts”—notices that appear only on the internal SERP system—that sidestep the normal clearance and disclosure process;<sup>4</sup>
- Has no procedure for clearing frequently asked questions (FAQs) posted on its website; and
- Does not disclose instructions to computers (called “functional specifications”). Thus, the IRS will become less transparent as computers replace employees, and undisclosed and uncleared instructions to computers replace disclosed and cleared instructions to employees.

In addition, decentralized responsibility for disclosure, problems with decision-making tools, and a lack of oversight, accountability, and training may exacerbate the IRS's FOIA compliance challenges, as follows.

- At the end of fiscal year (FY) 2010, the Internal Revenue Manual (IRM) contained 1,923 sections written by approximately 646 authors, whose FOIA determinations were subject to little oversight;<sup>5</sup>
- Although the IRS has automated decision-making tools to help authors determine if items should be disclosed and is taking steps to improve them, these tools could lead to under-disclosure;
- The IRS does not require all authors to attend FOIA training; and
- No single IRS function regularly measures or is responsible for the accuracy of the authors' FOIA or clearance determinations.

While it is difficult to ascertain the extent to which IRS authors improperly fail to disclose and clear instructions to staff, this difficulty stems from the IRS's failure to measure compliance. Moreover, the lapses described below occurred over a short period, suggesting the IRS should do more to evaluate and address the problem.

## ANALYSIS OF PROBLEM

### Background

#### *The Freedom of Information Act*

The Freedom of Information Act requires the IRS to make available to the public all “administrative staff manuals and instructions to staff that affect a member of the public,” unless an exemption applies.<sup>6</sup> Exemptions apply to instructions that: (1) “could reasonably

<sup>4</sup> SERP “alerts” are not subject to the clearance or disclosure process because they are not supposed to be used for issuing new procedures. See, e.g., IRM 1.11.8.7.2 (Jan. 3, 2011).

<sup>5</sup> Response to TAS information request (June 24, 2011).

<sup>6</sup> See 5 U.S.C. § 552(a)(2)(C). FOIA requires the agencies to disclose of a wide variety of materials, but this discussion focuses primarily on the requirement to disclose “staff manuals” and “instructions to staff.”

be expected to risk circumvention of the law,” or (2) are “related solely to internal personnel rules and practices.”<sup>7</sup> Amendments adopted in 1996 (called E-FOIA), require agencies to make items available electronically (*e.g.*, on the Internet).<sup>8</sup> The President recently committed to “an unprecedented level of openness in Government,” directing agencies to “adopt a presumption in favor of disclosure” and “take affirmative steps to make information public,” using modern technology to do so “timely.”<sup>9</sup> The Office of Management and Budget (OMB) and Department of Justice (DOJ) issued similar directives.<sup>10</sup>

In seeking to comply with E-FOIA and these directives, the IRS posts both the IRM and other non-exempt “instructions to staff” to its Electronic Reading Room (ERR), on the IRS.gov website.<sup>11</sup> If an item is not properly posted and indexed, it may not be “relied on, used, or cited as precedent” by the IRS against a taxpayer unless the taxpayer has actual and timely notice of its terms.<sup>12</sup> Accordingly, items should be indexed or at least organized in a logical manner on the ERR, rather than other parts of IRS.gov.

***Disclosing guidance allows it to be vetted, encourages comments from stakeholders, and helps taxpayers obtain consistent and fair results.***

As discussed in prior reports, if the IRS knows it will be posting its instructions to staff on the ERR, this sunshine provides an incentive for the IRS to develop reasonable instructions and vet them, incorporating comments from internal and external stakeholders.<sup>13</sup> Posting items also helps IRS employees identify and follow applicable procedures, promotes consistency, helps taxpayers and their representatives resolve tax problems and disputes with the IRS, and often prompts the public, or internal stakeholders (including TAS), to submit comments, which help the IRS improve its procedures.<sup>14</sup>

<sup>7</sup> 5 U.S.C §§ 552(b)(7)(E) and (b)(2). See also IRM 1.11.1.3.1.2.1 (Sept. 4, 2009).

<sup>8</sup> Electronic Freedom of Information Act Amendments of 1996, Pub. L. No. 104-231, § 4, 110 Stat. 3048 (Oct. 2, 1996).

<sup>9</sup> President of the United States, *Memorandum on Transparency and Open Government* (Jan. 21, 2009), [http://www.whitehouse.gov/the\\_press\\_office/Transparency\\_and\\_Open\\_Government/](http://www.whitehouse.gov/the_press_office/Transparency_and_Open_Government/); President of the United States, *Memorandum on the Freedom of Information Act* (Jan. 21, 2009), <http://www.gpo.gov/fdsys/pkg/FR-2009-01-26/pdf/E9-1773.pdf>.

<sup>10</sup> Office of Management and Budget (OMB), *Memorandum on Open Government Directive* (Dec. 8, 2009), <http://www.whitehouse.gov/open/documents/open-government-directive>; The Attorney General, *Freedom of Information Act* (Mar. 19, 2009), <http://www.justice.gov/ag/foia-memo-march2009.pdf>.

<sup>11</sup> The Electronic Reading Room is at <http://www.irs.gov/foia/article/0,,id=110353,00.html>. If material is not properly referenced, or is on the IRS website but omitted from the ERR, it may still be difficult for taxpayers to find. Perhaps for this reason, FOIA requires the material to be indexed. See 5 U.S.C. § 552(a)(2)(flush).

<sup>12</sup> See 5 U.S.C. § 552(a)(2)(flush) (emphasis added).

<sup>13</sup> The public notice and comment rulemaking process produces similar benefits. See 5 U.S.C. § 553. For this reason, courts give greater deference to regulations that have been subject to notice and comment procedures. See, e.g., *Mayo Found. for Med. Educ. and Research v. U.S.*, 131 S. Ct. 704 (2011). In addition, TAS needs to be able to review all of the IRS's instructions to staff to be able to fulfill its statutory duty to “identify areas in which taxpayers have problems in dealings with the Internal Revenue Service [and]... propose changes in the administrative practices of the Internal Revenue Service to mitigate [these] problems,” as it does when items are subject to the clearance process and posted. IRC §§ 7803(c)(2)(A)(ii)-(iii). When the IRS is not following “published” administrative guidance, the National Taxpayer Advocate is also required to construe the factors taken into account in determining whether to issue a Taxpayer Assistance Order in the manner most favorable to the taxpayer. IRC § 7811(a)(3). For a legislative proposal to improve the National Taxpayer Advocate's ability to advocate for taxpayers in connection with published guidance, see *Codify the Authority of the National Taxpayer Advocate to File Amicus Briefs, Comment on Regulations, and Issue Taxpayer Advocate Directives*, *infra*.

<sup>14</sup> Even the Regulatory and Policy Division of the Organization for Economic Co-operation and Development (OECD) has noted that to improve regulation, member countries should “[E]nsure that administrative procedures for applying regulations and regulatory decisions are transparent...”. See *OECD Guiding Principles on Regulatory Quality and Performance* 5 (Apr. 25, 2005), <http://www.oecd.org/dataoecd/24/6/34976533.pdf>.

*The IRS has procedures for clearing and disclosing “staff manuals” and certain “instructions to staff.”***THE IRM IS CLEARED AND POSTED TO IRS.GOV.**

The IRM states that “[I]nstructions to staff found in other sources should be incorporated into the IRM,” making it the single “official source of IRS instructions to staff.”<sup>15</sup> If all instructions to staff were, in fact, immediately incorporated into the official IRM, IRS compliance with E-FOIA would be relatively easy because each time an IRM is updated, the IRS’s Media and Publications function posts it to the ERR.<sup>16</sup>

However, the IRS often needs to distribute new instructions to staff before it can incorporate them into the official IRM. IRS program owners are supposed to “clear” substantial changes to the official IRM with other affected IRS functions, and in some cases with “specialized reviewers,” such as the IRS Office of Chief Counsel and the Taxpayer Advocate Service (TAS).<sup>17</sup> This clearance process is very important because it improves the quality of these instructions and helps to prevent the IRS from adopting procedures that unnecessarily burden taxpayers, are illegal, or simply ill-advised. It took the IRS 84 days, on average, to clear an IRM in FY 2010.<sup>18</sup>

**TWO TYPES OF “INTERIM GUIDANCE” ARE CLEARED AND POSTED TO IRS.GOV.**

If IRS program managers need to issue guidance between IRM revisions, they can issue “interim guidance,” which is supposed to be cleared in less than 30 days.<sup>19</sup> Interim guidance can take the form of “interim guidance memos” (IGMs) or “interim procedural updates” (IPUs).<sup>20</sup> IGMs are memos that generally make changes to procedures described in the IRM.<sup>21</sup> An IPU is a change to the IRM that is immediately reflected in an unofficial version of the IRM maintained on an *internal* IRS system called the SERP. The IRS also uses the term IPU to refer to a separate document that either (1) contains the specific change to the SERP IRM, or (2) summarizes the change.<sup>22</sup> In other words, unlike IGMs, which always contain the specific updated instructions to staff, IPUs sometimes only summarize changes,

<sup>15</sup> IRM 1.11.2.2 (May 4, 2010).

<sup>16</sup> See IRM 1.11.10.6 (Sept. 4, 2009).

<sup>17</sup> See *generally* IRM 1.11.9.3 (Dec. 28, 2010); IRM 1.11.9.4 (Dec. 28, 2010). Changes to working conditions of “Bargaining Unit” employees are reviewed by the Office of Workforce Relations, which is also a specialized reviewer. IRM 1.11.9.4.4 (Sept. 4, 2009). Accordingly, such changes may require “impact and implementation” negotiations with the National Treasury Employees Union (NTEU) before they can be implemented. *Id.*; IRM 6.711.1.6 (Oct. 15, 2010).

<sup>18</sup> Response to TAS information request (June 24, 2011). The normal clearance process is supposed to take 30 to 60 days. IRM 1.11.1.7 (Apr. 29, 2008); IRM 1.11.9.6.2 (Sept. 4, 2009).

<sup>19</sup> IRM 1.11.10.5.2 (Sept. 4, 2009). Pursuant to expedited procedures, the IRM clearance process itself could be completed in less than 30 days. IRM 1.11.9.6.3 (Sept. 4, 2009).

<sup>20</sup> The IRS does not have servicewide data regarding how long it takes to clear IGMs or IPUs. Response to TAS information request (June 24, 2011).

<sup>21</sup> IRM 1.11.10.3 (Sept. 4, 2009).

<sup>22</sup> See, e.g., IRM 1.11.6.4.3 (May 7, 2010). Changes are reflected on SERP within 24-48 hours. IRM 1.11.8.10 (Jan. 3, 2011).

the actual text of which appears only in the internal SERP IRM.<sup>23</sup> The IRS typically incorporates SERP IRM changes and IGMs into the official IRM the next time it is updated for the ERR, which could be more than a year later.<sup>24</sup> Thus, if the IRS did not disclose IGMs and IPU, the public would have no way to know what procedures the IRS was following during that period.

While the IRS has long been posting IGMs to the ERR, in 2010, it also began posting IPU.<sup>25</sup> Because IPU sometimes only provide a summary of the change, however, posting the IPU does not always provide the same level of transparency as posting IGMs.

### **The IRS has improved its transparency.**

The IRS has taken significant steps to improve its transparency since the National Taxpayer Advocate discussed the issue in her 2006 Annual Report.<sup>26</sup> It has improved internal guidance to eliminate erroneous references to a so-called “local guidance” exception to FOIA.<sup>27</sup> It has also incorporated instructions to staff from the formerly-separate and undisclosed Law Enforcement Manuals (LEMs) into appropriate IRMs. This allows taxpayers greater access to LEM information that does not need to be redacted.<sup>28</sup> In 2010, the IRS also began posting IPU to the ERR, as discussed above.<sup>29</sup> Finally, on September 22, 2011, the IRS improved the analytical tools that help IRS employees make disclosure decisions, incorporating some of the suggestions offered by TAS and IRS Counsel.<sup>30</sup>

### **Despite progress, challenges remain.**

#### *Decentralized responsibility for E-FOIA compliance remains a challenge.*

The Office of Servicewide Policy, Directives, and Electronic Research (SPDER) establishes procedures governing the IRM and other internal management documents (IMD), as well

<sup>23</sup> According to the Office of Servicewide Policy, Directives, and Electronic Research (SPDER) Annual Report, “[U]pdating the SERP IRM through SERP interim procedural updates (IPUs) risks compliance with FOIA requirements and creates multiple sources of guidance.” Director SPDER, FY 2010 Annual Report on the Internal Management Documents (IMD) Program (Dec. 2, 2010).

<sup>24</sup> Each IRM author is supposed to review the IRM annually and must revise it to incorporate any changes. See, e.g., IRM 1.11.2.3 (Sept. 4, 2009).

<sup>25</sup> Director SPDER, FY 2010 Annual Report on the Internal Management Documents (IMD) Program (Dec. 2, 2010). TAS previously recommended the IRS “ensure that updates to the SERP IRM are promptly reflected on the IRM that is posted to IRS.gov.” See National Taxpayer Advocate 2006 Annual Report to Congress 10-30 (Most Serious Problem: *Transparency of the IRS*). While posting IPU is not the same as updating the public IRM, it is a significant step in the right direction. Once an IPU is issued, the IRS typically posts it to IRS.gov within seven days. Response to TAS information request (June 24, 2011).

<sup>26</sup> See National Taxpayer Advocate 2006 Annual Report to Congress 10-30 (Most Serious Problem: *Transparency of the IRS*) (recommending, among other things, that the IRS: eliminate or clarify the “local guidance” exception; post IRM and interim guidance that contain “official use only” information to the ERR in a redacted form; and ensure that updates to the SERP IRM are promptly reflected on the IRM that is posted to IRS.gov).

<sup>27</sup> See Response to TAS information request (Mar. 30, 2011) (“SPDER has revised its guidance and training to eliminate the ‘local guidance’ exception”). We remain concerned, however, that business units are still authorized to issue “local procedures” that are not required to be incorporated into the IRM and not subject to the normal clearance process. Response to TAS information request (June 24, 2011) (“Local procedures issued outside of the IRM are cleared according to internal business process. The business unit is responsible for disclosing the procedures to the public. See IRM 1.11.2”).

<sup>28</sup> Response to TAS information request (Mar. 30, 2011) (“In FY 2010, we incorporated content from Law Enforcement Manuals into the IRM as embedded ‘official use only’ information.”).

<sup>29</sup> Response to TAS information request (Mar. 30, 2011) (“Beginning in February 2010, SERP IPU meeting FOIA criteria have been posted to IRS.gov.”).

<sup>30</sup> The IRS continued to revise and improve the tool after this draft was finalized for IRS response.

as providing guidance on E-FOIA compliance.<sup>31</sup> However, each IRS program manager and author of “instructions to staff” is responsible for his or her own FOIA compliance.<sup>32</sup> At the end of FY 2010, the IRM contained 1,923 sections written by approximately 646 authors, whose E-FOIA determinations are subject to little oversight.<sup>33</sup> No single IRS function regularly measures or is responsible for the accuracy of the authors’ E-FOIA determinations.<sup>34</sup>

SPDER makes E-FOIA training available to authors, and IRS business units may develop their own training.<sup>35</sup> Technical specialists in the IRS Office of Disclosure are also available to answer E-FOIA questions. However, the IRS has no mandatory E-FOIA training for authors of instructions to staff.<sup>36</sup> As a result, some authors may not know about the requirement to post items to the ERR, and no particular IRS function is responsible for training the authors or identifying undisclosed materials that they should have posted.

*E-FOIA decision-making tools are helpful, but could lead to inconsistent interpretation and under-disclosure.*

To help authors identify instructions to staff that must be disclosed, the IRS has developed two decision-making tools, which pose relevant questions.<sup>37</sup> SPDER’s E-FOIA decision tool is available on the IRS’s intranet. A similar set of questions pops up when an author submits an IPU on SERP.<sup>38</sup> As noted above, the IRS updated (and mostly conformed) both tools on September 22, 2011. Except as otherwise indicated, the questions embedded in these tools as of July 12, 2011, and September 22, 2011, are shown in the table below.<sup>39</sup>

<sup>31</sup> See IRM 1.11.1.1 (Sept. 4, 2009).

<sup>32</sup> IRM 1.11.1.3.1.1 (Apr. 20, 2010); IRM 1.11.10.6 (Sept. 4, 2009).

<sup>33</sup> Response to TAS information request (June 24, 2011) (citing data from the ESN database, and stating that “[O]ne SPDER employee monitors the ERR for instructions to staff that are outdated and notifies the program owner. Compliance with the E-FOIA law is the responsibility of the program owners.”).

<sup>34</sup> Response to TAS information request (June 24, 2011) (indicating that “[A]ccuracy data are not available”).

<sup>35</sup> *Id.*

<sup>36</sup> Response to TAS information request (June 24, 2011). The IRS could not provide the rate of turnover among IRM authors. *Id.*

<sup>37</sup> See, e.g., IRM 1.11.8.8.1.1 (Jan. 3, 2011) (SERP only); IRM 1.11.1.3.1.2.2 (Sept. 4, 2009).

<sup>38</sup> Use of the SERP decision tool became mandatory for IPU submissions on Feb. 1, 2010. SERP, New SERP IPU E-FOIA Training (2010). No similar questions appear when an author submits a “SERP alert” (described above).

<sup>39</sup> The IRS updated the SERP and SPDER tools on September 22, 2011. However, we have not removed our analysis of the prior versions of the tools because the versions that existed on July 12, 2011, may have contributed to the examples of under-disclosure we have identified. Moreover, the IRS may continue to update the tools in response to comments, potentially addressing some concerns while raising others. The September 22, 2011, versions have not addressed all of our concerns and we hope to continue working with the IRS to improve them.

**TABLE 1.20.1, SERP and SPDER E-FOIA Decision-Making Tools**

| SERP<br>(as of 7/12/2011)  | SPDER<br>(as of 7/12/2011)   | SERP/SPDER<br>(as of 9/22/2011)   |
|--|--|---|
| <p>1. Does the change revise procedural guidance (instructions to staff)? [Y=continue; N=no disclosure].</p> <p><b>Procedural guidance:</b> Directions, guidelines, or standards used by employees in the performance of their assigned duties.</p> <p><b>Examples:</b> Changes to the criteria for accepting offers in compromise are procedural guidance. Changes to employee resources, guidelines relating to employee travel, closure of offices, or workplace information do not convey procedural instructions to employees for the performance of their assigned duties.</p> | <p>1. Does the document (e.g. memo) convey instructions to employees? [Y=continue; N=no disclosure].</p> <p><b>Definition:</b> The document provides directions, guidelines or standards used by employees in their assigned duties.</p> <p><b>Example:</b> An interim guidance memo issued by the Program Director, which revises the procedures for accepting offers in compromise is subject to E-FOIA. A memo to employees about the upcoming open benefit season, or office closure does not convey procedural instructions to employees in the performance of their assigned duties.</p> | <p>1. Does the guidance provide directions, guidelines or standards used by employees in their assigned duties? [Y=continue; N=no disclosure].</p> <p><b>SERP Directions:</b> To determine E-FOIA criteria, answer the following questions for each change identified on the SERP IRM Update (IPU). This decision tool applies to all types of Interim Guidance. The word "guidance" in each question refers to all types of Interim Guidance including Interim Guidance Memoranda, SERP IPU's or other approved types of Interim Guidance under IRM 1.11.10.2.3, Interim Guidance Format.</p> <p><b>SPDER Directions:</b> To determine E-FOIA criteria, answer the following questions for each change identified on the SERP IRM Update (IPU). This decision tool applies to all types of Interim Guidance. The word "guidance" in each question refers to all types of Interim Guidance including Interim Guidance Memoranda, SERP IPU's or other approved types of Interim Guidance under IRM 1.11.10.2.3, Interim Guidance Format.</p> |
| <p>2. Does the change restate procedures or guidance released to the public on IRS.gov in another format? [N=continue; Y=no disclosure].</p> <p><b>Definition:</b> The content in the SERP IRM Update is restated if it is already in an IRS document released to the public on IRS.gov, such as IRS News Release, IR Bulletin or in a published IRM on IRS.gov.</p> <p><b>E-FOIA Example:</b> Content in an SERP IRM Update is in an IRS News Release on IRS.gov.</p>   | <p>2. Does the document restate procedures or guidance released to the public in another format? [N=continue; Y=no disclosure].</p> <p><b>Definition:</b> The content in the document is restated if it is available on IRS.gov.</p> <p><b>Example:</b> Memos conveying procedures or guidance already available in a published IRM on IRS.gov, an IRS News Release, or an Internal Revenue Bulletin are restatements.</p>   | <p>2. Does the guidance affect how a member of the public files, pays, complies with their tax requirements or interacts with the Service? [Y=continue; N=no disclosure].</p> <p><b>Content that affects the public:</b></p> <ul style="list-style-type: none"> <li>■ New procedures revenue officers must follow prior to the seizure of a principal residence.</li> <li>■ Changes in the criteria for accepting offers in compromise.</li> <li>■ Changes to taxpayer documentation requirements for a refund trace.</li> </ul> <p><b>Content that does not affect the public:</b></p> <ul style="list-style-type: none"> <li>■ Internal administrative procedures, e.g., travel regulations, personnel guidance, or staffing.</li> <li>■ Internal processing instructions, such as internal coding, work assignment, or inventory.</li> <li>■ Content about building safety procedures.</li> </ul>  |

| SERP<br>(as of 7/12/2011)  | SPDER<br>(as of 7/12/2011)  | SERP/SPDER<br>(as of 9/22/2011)   |
|--|---|---|
| <p>3. Does the change affect how the public files, pays, receives a refund, or complies with Federal income taxes? [Y=continue; N=no disclosure].</p> <p><b>E-FOIA Examples:</b> Changes to extensions to time to file a tax return would affect a member of the public. Changes to documentation needed for a refund trace would affect a member of the public.</p> <p><b>E-FOIA Exempt Examples:</b> Editorial changes where the revisions do not change the meaning of the content, do not affect a member of the public. Content relating to internal processing instructions, such as internal coding, work assignment, or inventory does not normally affect a member of the public.</p> | <p>3. Does the document affect a member of the public? [Y=continue; N=no disclosure].</p> <p><b>Definition:</b> If the content in the document affects how a member of the public files, pays, or complies with their tax requirements or interacts with the Service, then the document is considered to affect a member of the public.</p> <p><b>Example:</b> Content relating to internal administrative procedures, e.g., travel regulations, personnel guidance or staffing guidance does not affect a taxpayer. Editorial changes that do not change the meaning of the content also do not affect a member of the public.</p>   | <p>3. Is the guidance available in full on the Electronic Reading Room (ERR) on IRS.gov? [N=continue; Y=no disclosure].</p> <p><b>Previously Released to the Public on the ERR:</b></p> <ul style="list-style-type: none"> <li>The guidance is in a published IRM on IRS.gov.</li> <li>The guidance is merely a reminder to employees to follow current procedures already in a published IRM on IRS.gov.</li> <li>A SERP IPU issued to revise the FUTA tax rate which is contained in an IRS Notice posted on the ERR.</li> </ul> <p><b>Not Previously Released to the Public on the ERR:</b></p> <ul style="list-style-type: none"> <li>Instructions to employees describing details for a new procedure on accepting returns previously outlined in a press release.</li> <li>A re-issued interim guidance memorandum that affects a member of the public.</li> <li>A SERP IPU which revises procedures for FUTA tax calculation not available on the ERR on IRS.gov.</li> </ul>   |
| <p>4. Would failure to disclose the change adversely affect a member of the public or prevent them from pursuing an alternative course of action? [Y=continue; N=no disclosure].</p> <p><b>Definition:</b> A member of the public would be adversely affected or prevented from pursuing another action, if the information is not made available to them.</p> <p><b>E-FOIA Example:</b> A change in the failure to file penalty calculation would adversely affect the taxpayer, as the amount owed may be higher than expected. Not knowing about the change, the taxpayer is deprived of information that could alter their decision making.</p>  | <p>4. If the document was not made available to the public, would the public be adversely affected or prevented from pursuing an alternative course of action? [Y=continue; N=no disclosure].</p> <p><b>Definition:</b> A member of the public would be adversely affected or prevented from pursuing another action, if the information was not made available to them.</p> <p><b>Example:</b> An interim guidance memo was issued on handling non-hardship effective tax administration Offers in Compromise. The procedures include new instructions on handling these offers. Absent this information, a taxpayer may not have filed an Offer and as a result be unduly harmed. If the taxpayer had known about this change, the taxpayer might have taken other actions.</p> | <p>4. Does the guidance contain material that has been designated (or should be designated) Official Use Only (OUO) content? [Y=continue; N=no disclosure].</p> <p><b>Definition:</b> "Official Use Only" is sensitive information, the disclosure of which is prohibited by law or could adversely affect the conduct of IRS programs or operations essential to the administration of tax laws. See IRM 11.3.12, <i>Designation of Documents</i>. The Service does not generally consider employee phone numbers and names OUO. If you are unsure if the document contains OUO content, contact your Disclosure Technical Advisor.</p> <p><b>Information which should be/is OUO:</b></p> <ul style="list-style-type: none"> <li>Tolerance amounts which if released would impair tax administration.</li> <li>Information that describes a law enforcement technique which if released could permit circumvention of the law.</li> <li>Data processing materials and codes that if released to the public could interfere with the tax administration process.</li> <li>Settlement ranges for negotiation purposes that are included in Appeals Settlement Guidelines.</li> </ul> <p><b>Information that should not be considered OUO:</b></p> <ul style="list-style-type: none"> <li>A Mail Stop number provided for routing purposes.</li> <li>Computer Transaction codes.</li> <li>Threshold amounts such as income levels for the Earned Income Credit or exemption amounts.</li> </ul> |

| SERP<br>(as of 7/12/2011)  | SPDER<br>(as of 7/12/2011)   | SERP/SPDER<br>(as of 9/22/2011)  |
|--|--|--|
| <p>5. Does the change contain Official Use Only (OUO) content?<br/>[Y=continue; N=disclose].</p> <p><b>Definition:</b> OUO material must be protected from disclosure under the Internal Revenue Code, the Privacy Act, or if public release of the material would demonstrably harm tax administration. The Service does not generally consider employee phone numbers and names OUO.</p> <p><b>Examples of OUO information:</b> Tolerance amounts; information that describes a law enforcement technique; data processing materials and codes which might prove useful to a person attempting to abuse the tax administration process; taxpayer information; pre-decisional process documents such as an attorney work product.</p> | <p>5. Does the document contain Official Use Only (OUO) content?<br/>[Y=continue; N=disclose].</p> <p><b>Definition:</b> "Official Use Only" is a designation for information of a sensitive nature, the disclosure of which could adversely affect the conduct of IRS programs or operations essential to administering the tax laws. Use OUO classification when material must be protected from disclosure under the Internal Revenue Code, the Privacy Act, or if public release of the material would demonstrably harm tax administration.</p> <p><b>Example:</b> Tolerance amounts; information that describes a law enforcement technique; data processing materials and data processing codes which might prove useful to a person attempting to abuse the tax administration process; taxpayer information; and pre-decisional process documents such as an attorney work product are all OUO. The Service does not generally consider employee phone numbers and names OUO.</p> | <p>5. Would the guidance be meaningless to the reader if the OUO content were redacted?<br/>[Y=do not disclose; N=disclose redacted].</p> <p><b>Guidance is meaningless when OUO removed:</b></p> <ul style="list-style-type: none"> <li>■ A SERP IPU where all the changes are designated as OUO.</li> <li>■ A memorandum providing settlement guidelines to employees would be meaningless if the OUO content was removed.</li> </ul> <p><b>Guidance provides information with the OUO information removed:</b></p> <ul style="list-style-type: none"> <li>■ A SERP IPU adding a new subsection on processing casework with one tolerance amount designated as OUO.</li> <li>■ A memo outlining an audit process for offshore accounts that includes an audit tolerance amount.</li> </ul> |
| <p>6. Is the change entirely OUO?<br/>[Y=no disclosure; N=disclose redacted].<sup>40</sup></p>   | <p>6. Is the document primarily OUO?<br/>[Y=no disclosure; N=disclose redacted].</p> <p><b>Definition:</b> The document is primarily OUO if eliminating the sensitive content would render the document meaningless.</p> <p><b>Example:</b> A memo to employees revising an IDRS data processing code that indicates a criminal investigation is primarily OUO.</p>  |  |

While these tools are helpful, they are more complicated than the FOIA law (quoted above) and contain differences that could lead to inconsistent results. As illustrated below, some of the questions could also lead to under-disclosure. The revisions seem likely to address some but not all of these problems.

<sup>40</sup> The IRS updated the SERP tool on June 9, 2011, and July 8, 2011. One of these revisions conformed the language of question #6 of the SERP tool to the language of the SPDER tool by changing "entirely" to "primarily." While this change could prevent the IRS from posting documents so redacted as to be meaningless, it addresses a problem that does not exist. The IRS has rarely posted documents that were so overly-redacted that they were meaningless. The change could, however, promote under-disclosure because an author would have to read the examples to know that "primarily" is broadly defined. The September 22, 2011, change, however, was a significant improvement in this regard.

For example, on February 24, 2011, the IRS announced to the press that it was planning to increase the threshold for automatically filing a lien.<sup>41</sup> The next day, analysts for the Wage and Investment (W&I) and Small Business/Self Employed (SB/SE) divisions issued IPUs, revising various sections of the SERP IRM to increase the lien filing threshold.<sup>42</sup> The W&I author classified the revised threshold as “official use only” (OUO), but the SB/SE author did not.<sup>43</sup> In addition, the IRS did not post either IPU to the ERR on IRS.gov.<sup>44</sup>

About a month later, when SB/SE issued an IGM to update lien filing thresholds contained in different sections of the IRM, it posted the IGM to the ERR and did not classify the thresholds as OUO.<sup>45</sup> Thus, the authors of the IPUs and IGM apparently reached different conclusions about whether they were required to disclose the change and whether the lien filing thresholds were OUO.

Several of the questions posed by the decision-making tools (above) could lead the authors of the IPUs to incorrectly conclude that disclosure was not required. In response to question #2, an author might believe the change had been described to the public (albeit in less detail) as part of the IRS news release; therefore, disclosure was not necessary.<sup>46</sup> Similarly, the author could decide in response to question #3 of the SERP tool that the change did not “affect how the public files, pays, receives a refund, or complies,” but rather how the IRS would enforce the rules or how taxpayers might obtain relief from enforced collection.<sup>47</sup>

In response to question #4, an author might conclude that the nondisclosure would not “adversely affect a member of the public or prevent them from pursuing an alternative course of action.”<sup>48</sup> The author might reason that nondisclosure would not adversely affect a taxpayer because the change was favorable to taxpayers; nor would it “prevent” the taxpayer from pursuing any alternative course of action with the IRS. For example, a taxpayer could still receive the benefit of the increased lien filing threshold, even if he or she did not know about it. It might not occur to the author that those taxpayers with liabilities below

<sup>41</sup> IR-2011-20 (Feb. 24, 2011), <http://www.irs.gov/newsroom/article/0,,id=236540,00.html>. Although not printed in the IRS release, the amount of the new threshold was announced by IRS officials and reported by the press. See, e.g., Jeremiah Coder, *ABA Section of Taxation Meeting: IRS Trying to Improve Penalty Process, Officials Say*, 131 Tax Notes 683 (May 16, 2011).

<sup>42</sup> SERP IPU 110444 (Feb. 25, 2011) updated the lien filing thresholds that appeared at IRM 5.19.4.5.2 (Mar. 8, 2010). SERP IPU 110460 (Feb. 25, 2011) updated the lien filing thresholds that appeared at IRM 5.19.1.7 (Nov. 3, 2010).

<sup>43</sup> SERP IPU 110460 (Feb. 25, 2011) (marking the threshold as OUO); SERP IPU 110444 (Feb. 25, 2011) (not marking the threshold as OUO).

<sup>44</sup> As of August 26, 2011, neither IPU was posted to the ERR as a change to IRM 5.19.

<sup>45</sup> See IGM SBSE-05-0311-039 (Mar. 28, 2011), <http://www.irs.gov/pub/foia/ig/sbse/sbse-05-0311-039.pdf> (updating the thresholds appearing at IRM 5.12.2.4 (Oct. 30, 2009)). TAS's inquiry regarding the IRS's non-disclosure of various materials could have influenced the IRS's handling of this IGM. Email from TAS to Disclosure (Mar. 17, 2011).

<sup>46</sup> The revised tools eliminated this ambiguity by requiring disclosure unless the item was available in full on the ERR. Except as otherwise indicated, our references to questions numbers are to the questions presented by the tools as of July 12, 2011.

<sup>47</sup> Question #3 of the SPDER tool (as of 7/12/2011) was less limiting because it provided that a document should also be disclosed if the change would affect how a taxpayer “interacts with the Service.” Because the term “interacts” is vague and limiting, however, this addition does not fully address the concern. Question #2 of the revised tools retained the language provided in question #3 of the SPDER tool (as of 7/12/2011).

<sup>48</sup> The revised tools eliminated this question.

the threshold, if aware of the change, could potentially take additional steps, such as seeking to have a lien filing withdrawn.

Finally, under FOIA, information compiled for law enforcement purposes is exempt from disclosure if it “could reasonably be expected to risk circumvention of the law.”<sup>49</sup> By contrast, under question #5 and the IRM’s seemingly broader definition, material is exempt as OOU if it includes, among other things, “[i]nstructions relating to enforcement strategies, methods, procedures, tolerances and criteria,” without regard to whether it could reasonably be expected to risk circumvention of the law.<sup>50</sup> This discrepancy could lead to under-disclosure and inconsistency, as illustrated above.<sup>51</sup>

Perhaps the W&I author viewed the threshold as a “tolerance,” which the decision tool suggests is always OOU. By contrast, the two SB/SE authors and the IRS officials who announced the threshold to the press may have believed it was not.<sup>52</sup> The National Taxpayer Advocate does not believe disclosure of the lien filing threshold “could reasonably be expected to risk circumvention of the law.” The IRS should at least encourage authors to ask this question, rather than relying on the untested assumption that they understand the difference between a threshold and a “tolerance.” Moreover, in light of the Presidential, OMB, and DOJ directives discussed above, it should resolve ambiguity in favor of disclosure. The revised tools are a step in the right direction because they do not provide a blanket exception for tolerances unless the disclosure “would impair tax administration.”

### *The IRS has no procedures for clearing and posting SERP Alerts and similar documents.*

Program managers sometimes communicate with IRS employees without issuing IGMs, IPUs, and IRM changes. For example, they may distribute email, training materials, and internal newsletters, and post “alerts” on SERP.<sup>53</sup> Such alternate forms of communication are not exempt from E-FOIA’s posting requirement. However, the IRS does not have procedures for posting them to the ERR because they are only supposed to contain information that does not have to be posted or is already described in documents that are posted.<sup>54</sup> For the same reasons, these alternate forms of communication are not subject to clearance

<sup>49</sup> 5 U.S.C. § 552(b)(7)(E). While there are other types of law enforcement exemptions, they are generally inapplicable in the context of this discussion. *Id.*

<sup>50</sup> IRM 1.11.2.12 (Sept. 4, 2009).

<sup>51</sup> As SPDER’s annual report notes, “[I]ncorrectly designating official use only material may place sensitive information in the public domain. Withholding more information than necessary may, however, violate the Freedom of Information Act (FOIA) requirements.” Director SPDER, FY 2010 Annual Report on the Internal Management Documents (IMD) Program (Dec. 2, 2010).

<sup>52</sup> IGM SBSE-05-0311-039 (Mar. 28, 2011) (revealing the new threshold to the public); Jeremiah Coder, *ABA Section of Taxation Meeting: IRS Trying to Improve Penalty Process, Officials Say*, 131 Tax Notes 683 (May 16, 2011) (same).

<sup>53</sup> See, e.g., IRM 1.11.6.4.3 (May 7, 2010); IRM 1.11.8.7.2 (Jan. 3, 2011). Changes are reflected on SERP within 24-48 hours. IRM 1.11.8.10 (Jan. 3, 2011). So-called “newsflashes” and “hot topics” may also appear on SERP. See IRM 1.11.9.8(5) (Sept. 4, 2009); IRM 1.11.10.6.1 (Sept. 4, 2009).

<sup>54</sup> See, e.g., IRM 1.11.8.7.2 (Jan. 3, 2011) (“Use Alerts to notify users of system problems, changes, and information (e.g., Disaster Assistance Information) that do not require an IRM procedure/instruction change.”).

by other functions, such as TAS, as is required for IGMs and IPU's.<sup>55</sup> Thus, uncleared and undisclosed SERP alerts can pose a problem when they discuss new procedures.

For example, in the first week of March, 2011, the IRS issued SERP alerts that communicated instructions to staff regarding the IRS's intention to expand the availability of in-business installment agreements and lien withdrawals, as previously announced in a February 24, 2011 press release.<sup>56</sup> The IRS sometimes disseminates this type of guidance internally by issuing alerts on SERP because it can do so more quickly than by issuing procedural updates or revising the IRM, which both require formal clearance.<sup>57</sup> As noted above, SERP alerts are not posted to the ERR. As a result, taxpayers remained unaware of the specific procedures they could have used to obtain installment agreements or lien withdrawals because the IRS used a SERP alert to issue the guidance.

As another example, on August 20, 2010, the IRS used a SERP alert to provide procedural protections to taxpayers, as required by a recent court decision.<sup>58</sup> The SERP alert instructed employees that if a taxpayer had an "economic hardship," the employee should put the account in "currently not collectible" (CNC) status to prevent further collection activity, even if the taxpayer had unfiled returns.<sup>59</sup> By contrast, then-applicable IRM provisions instructed "[D]o NOT report any cases as CNC (hardship) until all delinquent returns are filed."<sup>60</sup> Because this change was not disclosed, practitioners seeking to assist taxpayers facing economic hardships could not advocate for them as effectively. Moreover, some IRS employees could have been confused about how to reconcile the conflicting instructions. Such confusion could cause employees to take actions that harm taxpayers and open the IRS to legal challenge.

An alert issued on July 25, 2011, further illustrates the problem of using SERP alerts to bypass the clearance and E-FOIA procedures.<sup>61</sup> The text of the alert is reproduced as follows:

<sup>55</sup> IRM 1.11.9.8(1) (Sept. 4, 2009) (noting that interim guidance is subject to the same clearance procedures as the IRM, except it is subject to shorter clearance timeframes).

<sup>56</sup> SERP Alert 110191 (Mar. 1, 2011), SERP Alert 110187 (Mar. 2, 2011), and SERP Alert 110195 (Mar. 2, 2011). These alerts were not disclosed, but were inexplicably rescinded over three months later on June 17, 2011. In addition, the IRS did not disclose IPU's, which made similar changes to the SERP IRM. IPU 111039 (May 23, 2011); IPU 110446 (Feb. 28, 2011). These nondisclosures affected the public because the National Taxpayer Advocate cited the changes in her public statements and members of the public had to contact TAS to obtain the source documents that she cited.

<sup>57</sup> SERP alerts received by 3 p.m. are available the next day and IPU's are available within 24-48 hours. IRM 1.11.8.10 (Jan. 3, 2011). However, IPU's must be circulated for clearance by other functions. See IRM 1.11.9.8 (Sept. 4, 2009). The IRS can clear interim guidance, such as IPU's, in less than the 30 days it takes to clear an IRM, but clearance still takes time. IRM 1.11.10.5.2 (Sept. 4, 2009) (providing for clearance in less than the 30 days applicable to IRM updates).

<sup>58</sup> See *Vinatieri v. Comm'r*, 133 T.C. No. 16 (2009). For discussion of this case and the need for guidance, see National Taxpayer Advocate 2010 Annual Report to Congress 85-97 (Most Serious Problem: *IRS Collection Policies and Procedures Fail to Adequately Protect Taxpayers Suffering an Economic Hardship*) (recommending the IRS "revise its IRM and other procedural guidance to clarify that all collection employees are authorized to ... place a taxpayer's account into CNC status based on economic hardship, without securing unfiled returns...").

<sup>59</sup> SERP Alert 100440 (Aug. 20, 2010). The IRS issued a similar alert on October 27, 2010. SERP Alert 100539 (Oct. 27, 2010). For procedures that TAS will follow in these cases, see IGM, TAS-13.1.10-0311-008 (Mar. 29, 2011), [http://www.irs.gov/pub/foia/ig/tas/tas\\_13.1.10-0311-008.pdf](http://www.irs.gov/pub/foia/ig/tas/tas_13.1.10-0311-008.pdf).

<sup>60</sup> IRM 5.19.1.7.1(8) (Mar. 25, 2009) (emphasis in original). The IRM was not formally revised to reflect the guidance provided by the alert until November 3, 2010. IRM 5.19.1.7.1.5 (Nov. 3, 2010).

<sup>61</sup> SERP Alert 110514 (July 25, 2011). The alert was revised on July 26, 2011, to add the following sentence: "If taxpayers disagree with the letter, follow procedures in IRM 21.6.3.4.2.11.6, *First-Time Homebuyer Credit Claims*." *Id.*

Last year, TIGTA identified some taxpayers who claimed the First-Time Homebuyer Credit with a purchase date prior to the date of enactment (04/09/08). For taxpayers claiming the Long-Time Residents Credit, the date of enactment was 11/06/09. **These taxpayers reported a timely date on their Form 5405, but 3rd party reporting shows an earlier date.**

**A bulk process is currently being used to reverse the FTHBC and issue a 105C disallowance letter.** The adjustments will be staggered over a 3-week period, which started July 18.... [computer codes omitted]

If taxpayers disagree with the letter, they must submit a HUD-1 statement. [Emphasis added.]

The IRS sent Letter 105C, *Claims Disallowed*, to 36,000 taxpayers.<sup>62</sup> However, the IRS did not have the authority to recover the FTHBC in this manner based solely on an apparent discrepancy between the purchase date reported on the return and the purchase date reflected in third-party data.<sup>63</sup> In other words, if the IRS determined to disallow these claims it was required to issue a “statutory notice.”<sup>64</sup> The statutory notice would have given the taxpayer the right to petition the Tax Court.<sup>65</sup> In addition, the language included in Letter 105C was confusing and misleading to taxpayers who had already received the credit. The letter stated a taxpayer could only appeal the IRS determination to Appeals if the IRS disallowed the claim because it was late.<sup>66</sup> These taxpayers had not filed late claims. If they had, they would not have received the FTHBC.

On July 27, 2011, after the National Taxpayer Advocate drew this matter to the IRS's attention, the IRS concluded it should not have been using Letter 105C.<sup>67</sup> It followed up on August 4, 2011, by drafting a letter for the 36,000 taxpayers who had received Letter 105C, apologizing for the confusion and indicating the credit was not disallowed.<sup>68</sup> If the IRS's procedures governing this “bulk process” had been properly documented, cleared, and

<sup>62</sup> Response to TAS information request (Sept. 13, 2011).

<sup>63</sup> The IRS was making an adjustment based on inconsistencies between the date of purchase shown on the return and the date of purchase reflected in third-party data. The IRS's general authority to make math error adjustments under IRC § 6213(g)(2)(C) only applies when one item on a return is inconsistent with another. We understand the IRS mistakenly believed, based on an informal discussion with Counsel, that it could use math error authority to make these reversals.

<sup>64</sup> IRC § 6212.

<sup>65</sup> IRC § 6213(a).

<sup>66</sup> Letter 105C, *Claim Disallowed* (May 3, 2010) (“You may appeal our decision with the Appeals Office (which is independent of our office) if we disallowed your claim because our records show that you filed your claim late.”).

<sup>67</sup> The IRS did not clear the procedures described in the alert. Rather, on July 26, 2011, TAS proactively identified these letters as problematic and convinced the IRS to stop sending them. Further, the IRS issued the alert only after it began sending out these letters. Response to TAS information request (Sept. 13, 2011).

<sup>68</sup> SERP Alert 110544 (Aug. 4, 2011). The IRS had problems systemically correcting the accounts. SERP Alert 110591 (Sept. 2, 2011).

disclosed, or if the SERP alert that described changes to those procedures had been cleared, the IRS is more likely to have avoided these problems.<sup>69</sup>

### FAQs ARE NOT CLEARED OR INCLUDED IN THE IRM, AND NEITHER ARE UPDATES TO FAQs.

The IRS often posts “frequently asked questions” (FAQs) on its website.<sup>70</sup> While some FAQs simply restate previously disclosed material, some do not.<sup>71</sup> For example, as noted above, the IRS recently described the procedures that both its employees and taxpayers should follow in connection with a settlement initiative—called the 2009 Offshore Voluntary Disclosure Program (OVDP)—using FAQs on its website rather than the IRM, an Announcement, a Notice, or a Revenue Procedure.<sup>72</sup> On March 1, 2011, the IRS, intending to clarify what it viewed as a common misinterpretation of one key FAQ (OVDP FAQ #35) by its revenue agents, sent them a “secret” memo that was not subject to the clearance process or timely released to the public.<sup>73</sup> The IRS’s reinterpretation of the seemingly unambiguous language of FAQ #35 led to charges that it had used “bait and switch” tactics, eroding trust for the IRS.<sup>74</sup> It also left the public with the impression the IRS was inconsistently and arbitrarily denying some taxpayers the benefits of FAQ #35, which remained unchanged on its website. Neither the FAQs nor the “secret” clarifying memo had been cleared by TAS. The IRS has no written procedures for clearing FAQs with any internal stakeholders.<sup>75</sup> Moreover, we understand that other technical interpretations of the FAQs were communicated by word of mouth, rather than by written documents that could be

<sup>69</sup> For a discussion of the problems with using summary procedures such as the math error process to deny (or recover) First-time Homebuyer Credits based on unreliable third-party data, see Most Serious Problem: *Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayers Rights*, *supra/infra*; *Complexity and the Tax Gap: Making Tax Compliance Easier and Collecting What's Due*, Hearing Before the Senate Comm. on Finance Sen. Fin. Comm. (June 28, 2011) (statement of Nina E. Olson, National Taxpayer Advocate); National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, at 100-103 (*Administrability Problems Specific to the First Time Homebuyer Credit*); National Taxpayer Advocate 2002 Annual Report to Congress 185 (Legislative Recommendation: *Math Error Authority*).

<sup>70</sup> Jeremiah Coder, *How Do FAQs Fit into the Guidance Puzzle?* (Mar. 31, 2011) (noting that a simple search of the phrase “frequently asked questions” on the IRS website returned more than 1,300 results.).

<sup>71</sup> *Id.* (discussing the wide variety of FAQs that represent the IRS’s only public statement addressing various issues, and raising questions about reliance, the review process, judicial deference, and the lack of any way to search for archived FAQs).

<sup>72</sup> See IRS, *Voluntary Disclosure: Questions and Answers*, <http://www.irs.gov/newsroom/article/0,,id=210027,00.html> (Feb. 9, 2011) (first posted May 6, 2009) (OVDP FAQ). The IRS has continued to use this FAQ approach for new settlement initiatives. See IRS, 2011 *Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers*, <http://www.irs.gov/businesses/international/article/0,,id=235699,00.html> (Aug. 19, 2011) (first posted Feb. 8, 2011) (OVDP FAQ). In contrast, previous settlement initiatives have been promulgated using vehicles such as revenue procedures and announcements, which are published in the Internal Revenue Bulletin. See, e.g., Rev. Proc. 2003-11, 2003-1 C.B. 311 (Offshore Voluntary Compliance Initiative); Ann. 2004-46, 2004-1 C.B. 964 (“Son-of-Boss” settlement initiative). Such documents are subject to significantly more internal clearance and commentary than changes to the IRS.gov website. For a more detailed discussion of this problem, see Most Serious Problem, *The IRS’s Offshore Voluntary Disclosure Program “Bait And Switch” May Undermine Trust for the IRS and Future Compliance Programs*, *supra/infra*.

<sup>73</sup> Memorandum from Director, SB/SE Examination, and Director, International Individual Compliance, for all OVDP Examiners, *Use of Discretion on 2009 OVDP Cases* (Mar. 1, 2011). For a discussion of the resulting damage to the tax system, see Most Serious Problem: *IRS Offshore Voluntary Disclosure Program “Bait and Switch” May Undermine Trust for the IRS and Future Compliance Programs*, *supra/infra*. To be clear, the March 1 memo was not designated as “secret” or ODU. The IRS eventually posted it in response to a Taxpayer Advocate Directive issued by the National Taxpayer Advocate on August 16, 2011. See Taxpayer Advocate Directive 2011-1 (*Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and comply with the Freedom of Information Act*) (Aug. 16, 2011), available at <http://www.irs.gov/advocate/article/0,,id=251887,00.html>. The March 1 memo is available at [http://www.irs.gov/pub/irs-drop/ovdi\\_memo\\_use\\_of\\_discretion\\_3-1-11.pdf](http://www.irs.gov/pub/irs-drop/ovdi_memo_use_of_discretion_3-1-11.pdf).

<sup>74</sup> See, e.g., Pedram Ben-Cohan, *IRS’s Offshore Bait and Switch: The Case for FAQ 35*, 46 DTR J-1 (Mar. 9, 2011).

<sup>75</sup> Response to TAS information request (June 24, 2011) (“Frequently asked questions (FAQs) on IRS.gov are not internal management documents. Therefore, SPDER is not responsible for providing guidance on clearing and disclosing these documents.”).

cleared and disclosed.<sup>76</sup> The content of both the OVDP FAQs and the clarifying memo, and the IRS's overall handling of the problem could have been improved if the material had been subject to normal clearance and disclosure procedures.

#### APPLYING FOIA IN THE 21<sup>ST</sup> CENTURY: PROCEDURES FOLLOWED BY IRS COMPUTER PROGRAMS ARE NOT CLEARED OR POSTED.

As we reported last year, the IRS also establishes policies and procedures by embedding them in its computer systems, without subjecting them to internal clearance or disclosure.<sup>77</sup> IRS program managers communicate these policies and procedures to computer programmers by creating so-called "functional specifications" for the programs. As such, functional specifications may constitute instructions to staff (*i.e.*, the programmers, the computer operators, and the computers themselves) that should be disclosed if they affect the public, at least to the extent they are not OOU. *Moreover, if the IRS is required to disclose the decision-making processes that a human employee uses to make a determination, the same processes should not be immune from disclosure simply because they are embedded in software or carried out by machines.* For example, a program called the "reasonable cause assistant" (RCA) automatically determines if a taxpayer's failure to meet certain requirements was due to "reasonable cause."<sup>78</sup> If so, the IRS will abate the penalty that would otherwise apply. The program bases these determinations on answers to relevant questions that were probably included in the functional specification. The IRS suggested in its response to last year's report that its computer programming simply automates existing policies and procedures that have already been subject to clearance and disclosure. Thus, it argued, these policies and procedures do not need to be disclosed.

However, the questions posed by the RCA program, updates to these questions, and other functional specifications are not subject to the clearance process and are not available to the public even in redacted form. In each case, disclosure would help the taxpayer identify what facts are relevant in making the case for penalty abatement. We continue to believe the IRS should disclose its functional specifications along with any changes to them, provided they affect the public and are not exempt from disclosure. If the IRS does not disclose functional specifications, it will become less and less transparent in the 21st century, as technological advances increasingly allow computers to replace staff and instructions to computers to replace instructions to staff. As they do, instead of automating existing policies, the IRS will more often automate new policies and procedures that were never cleared or disclosed to the public before.

<sup>76</sup> An unpublished internal newsletter stated, however, that "[E]xaminers assigned OVDI cases have access to guidance on a secured OVDI SharePoint site. Technical Services Reviewers may access the secured ARI SharePoint site for additional guidance and contacts." SB/SE Technical Services, *Keys to Success 2* (Dec. 2010).

<sup>77</sup> National Taxpayer Advocate 2010 Annual Report to Congress 71-84 (Most Serious Problem: *IRS Policy Implementation Through Systems Programming Lacks Transparency and Precludes Adequate Review*).

<sup>78</sup> See, e.g., IRM 20.1.1.3.6 (Dec. 11, 2009); IRM 5.1.15.16.1 (Apr. 16, 2010); IRM 21.2.2.4.5.1 (Jan. 20, 2010).

## CONCLUSION

The IRS has taken a number of important steps to improve its transparency since our last report. However, decentralized responsibility for disclosure, inadequate training, a lack of accountability, and opportunities to improve internal decision-making tools remain challenges.

Failures to timely and properly disclose instructions to staff that affect the public not only violate FOIA and directives from the President, DOJ, and the OMB, but can have serious negative consequences. In such cases, taxpayers, practitioners, and IRS employees are less likely to be aware of the IRS's current procedures. As a result, they will be less effective in resolving tax problems and disputes. Additionally, the IRS is more likely to act or be perceived as acting arbitrarily and inconsistently, and is less likely to receive valuable comments from internal and external stakeholders that it could use to improve its procedures. As the examples above demonstrate, the failure to timely follow the clearance and disclosure rules, can result in guidance or procedures that are ill-advised, damage the tax system, deprive taxpayers of procedures designed to protect them, and possibly even violate the law.

In conclusion, the National Taxpayer Advocate preliminarily recommends that the IRS:

1. Assign one office within the IRS the responsibility to measure and improve the accuracy of E-FOIA and clearance determinations;
2. Require all IMD authors to attend E-FOIA training;
3. Continue efforts to improve internal SERP and SPDER E-FOIA decision-making tools;
4. Require employees submitting SERP alerts to use a decision-making tool to determine if the alert should be disclosed or issued as an IPU or IGM;
5. Establish a transparent process for periodically selecting a random sample of IMD and SERP alerts (and other internal communications, if practical) to identify the magnitude and source of the IRS's E-FOIA compliance challenges;
6. Establish a process for clearing FAQs; and
7. Establish a process for disclosing functional specifications.

## IRS COMMENTS

### Overview

The IRS takes very seriously the obligation to be transparent to taxpayers. Compliance with the Freedom of Information Act and the Open Government Initiative are of utmost importance to the agency. FOIA requires administrative staff manuals and instructions to staff that affect a member of the public to be made available to the public in an electronic form (unless an exemption applies). The Open Government Initiative encourages agencies to exercise their discretion to make a broader range of records available beyond the minimum required by statute. The IRS strives to continuously improve its processes and

procedures to ensure compliance. We disagree with the assertion that current practices may violate the law. We have consulted with the Office of Chief Counsel and confirmed that current practices are fully compliant with the legal requirements.

The Internal Revenue Manual totaling over 82,000 pages is the primary, and largest, source of the IRS's instructions to staff. The IRM, with sensitive information redacted, is automatically published to the Electronic Reading Room on IRS.gov and available to the public within 14 days of revision. Interim guidance, issued through memoranda or as a SERP Interim Procedural Update, is used to convey immediate, time-sensitive, or temporary changes to operations or instructions to employees prior to incorporation into the IRM. Interim guidance is evaluated for disclosure under FOIA 5 U.S.C 552(a)(2)(C) and is posted, as applicable, to the Electronic Reading Room on IRS.gov, typically within 14 days of issuance. In FY 2011, the IRS issued approximately 1,900 IPU's and 133 interim guidance memorandums. The IRS posted 103 interim guidance memorandums and 29 SERP IPU's. Based upon a statistically valid sample of SERP IPU's, 96.1 percent were correctly classified.<sup>79</sup> When the issues are identified with respect to the IRS's overall compliance with FOIA, the IRS takes actions as appropriate.

### Significant Improvements

In August 2011, the Deputy Commissioners issued a memorandum to all IRS employees confirming our commitment "to implementing openness in Government to ensure the public trust and establish a system of transparency, public participation, and collaboration." IRS employees were directed to respond timely to requests for records and agency information. The IRS actively pursues solutions and implements improvements to comply with the FOIA and with the Open Government Initiative.

A number of significant improvements have been made in recent years. Some of these include the following. In 2008, the IRS established a task team that reviewed clearance procedures for Internal Management Documents, identified problem areas, and recommended solutions which included expansive guidance and extensive training. In 2009, the IRS published significantly revised guidance for authoring, clearing, and publishing "instructions to staff." New in-depth IRMs were published on Clearance (IRM 1.11.9) and Interim Guidance (IRM 1.11.10). Also in 2009, a servicewide task force convened to identify problems relating to issuing and clearing interim guidance. In 2010, the IRS implemented procedures for evaluating SERP IPU's for E-FOIA determination and posting the content to the ERR on IRS.gov. In 2010, the IRS also implemented significant changes to the clearance procedures for "instructions to staff" to address concerns from the National Taxpayer Advocate. In January 2011, the IRS launched Open Government Initiative on IRS.gov. In September 2011, the IRS issued revised procedures for FOIA compliance of instructions to staff based on guidance from Chief Counsel. The SPDER and SERP E-FOIA decision tools were revised in accord with these procedural changes. In October 2011, the IRS published

<sup>79</sup> The sample was selected from 1,983 SERP IPU's issued from July 1, 2010, through June 30, 2011. Margin of error is three percent.

revised E-FOIA guidance and clearance procedures in the IRM. IRM 1.11.10, *Interim Guidance Process*, clarifies the requirements for clearing interim guidance memoranda and SERP IPUs and revises the E-FOIA determination. The IRS also revised the SPDER and SERP E-FOIA decision tools to address concerns from the National Taxpayer Advocate.

With respect to specific areas raised by the report of the National Taxpayer Advocate, the IRS would like to note the following.

#### *Decentralized Responsibility of Disclosure*

The Office of Disclosure is responsible for the policies governing the disclosure of IRS documents. The Office of Servicewide Policy, Directives and Electronic Research is responsible for developing the policies and procedures for managing “instructions to staff.” These offices work collaboratively and effectively, with Chief Counsel, to ensure that IRS complies with FOIA. The responsible program owner has responsibility to disclose content that meets E-FOIA. Technical training on general FOIA issues and the specific decisions required in determining whether or not to publish instructions to staff is available to IRS employees with these duties. Because the IRM is automatically redacted and disclosed to the public, only authors who issue interim guidance must determine whether the content should be published. In FY 2011, more than 200 employees attended E-FOIA training.

#### *E-FOIA Decision Tool*

The National Taxpayer Advocate Annual Report to Congress discusses the previous E-FOIA decision tools, which the IRS no longer uses because improvements were incorporated into a revised version. The current revised E-FOIA decision tool, October 12, 2011, is not evaluated in this report. The report discusses content in previous E-FOIA decision tools that has been eliminated or has been rewritten, with examples, specifically to address the National Taxpayer Advocate’s concerns. Thus, for example, the criticism of former question 4 (whether nondisclosure would prevent a taxpayer from seeking an alternative course of action) is moot as the question has been removed entirely from the decision tool. Comments about former question 2 (whether a document merely restates guidance already released) focus on the prior version of the decision tool. The current tool provides that only documents already published in full in the ERR of IRS.gov can be considered previously released for E-FOIA purposes. The examples for this question in the current tool address the concern cited by the National Taxpayer Advocate. Similarly, in discussing former question 3, while the report states that an instruction changing a lien threshold amount might not be considered by an employee to “affect how the public files, pays, receives a refund, or complies,” the report fails to note that the question as currently written includes the catch-all phrase “or [how a member of the public] interacts with the Service.” The current tool specifically includes an enforcement procedure as an example of an instruction topic that affects how the public “interacts” with the Service.

The IRS welcomes and responds to recommendations to its procedures and recognizes that there may be instances when there is room for improvement. While the report does

acknowledge some of the changes to the tool in footnotes, much of the discussion in the report has been addressed by improvements we have made. The IRS believes that the revised E-FOIA decision tool, with its specific examples, makes the publication requirement of the FOIA easier, not more difficult, for employees to understand.

### *SERP Alerts*

SERP Alerts notify users of system problems, changes, or information such as disaster assistance that do not require an IRM procedure/instruction change. SERP Alerts do not change current procedures or guidelines issued in the IRM or via a SERP IPU.<sup>80</sup> They are not a type of document that requires E-FOIA determination. While the IRS issued a SERP Alert to inform employees of the availability of in-business installment agreements and lien releases as announced in a February 24, 2011 Fresh Start Initiative press release, related IPUs were also issued. Some of these IPUs did not meet E-FOIA criteria, and thus were not posted to the ERR. Interim guidance memoranda pertaining to the Fresh Start initiatives were posted to the ERR. The Fresh Start Initiative press release also disclosed this information to the public. The SERP office in September 2011 changed procedures relating to SERP Alerts. The SERP office returns all Alerts changing IRM content to the author to be issued as a SERP IPU.

### *Frequently Asked Questions (FAQs) on IRS.gov*

The clearance and approval requirements for content on IRS.gov are governed by Online Services per IRM 2.25.101.4.2, *IRS.gov Content Management Guidelines, Pre-CMA Approval*. Per these instructions, Frequently Asked Questions posted on IRS.gov are reviewed and approved by the Operating Division and Functional area.

### *Disclosure of Functional Specification*

The National Taxpayer Advocate recommends the IRS establish a process for disclosing functional specifications for the purpose of being transparent. Necessary transparency should, and already does, take place distinct from the programming of systems. IRS systems should not define or create new policy decisions, only reflect and implement established policy and law. The IT systems development life cycle provides the process and mechanism to review and confirm the policy and law are accurately programmed. Programming is based on procedures and processes available to the public. In the event the IRS learns that programming reflects a procedure or policy not available to the public, changes are made accordingly so that appropriate transparency exists.

### *Response to Recommendations*

The IRS agrees that measuring and monitoring “instructions to staff” (See 5 USC § 552 (a)(2)(C)) is essential to ensuring compliance with E-FOIA. The Office of SPDER is responsible for managing instructions to staff and works closely with the Office of Disclosure and

<sup>80</sup> IRM 1.11.8.7.2, *Adding Alerts* (Jan. 3, 2011).

Chief Counsel to ensure compliance with E-FOIA. The Office of SPDER has conducted sample reviews of IPU, clearance, and other processes related to managing instructions to staff. The Office of SPDER, in coordination with the Office of Disclosure and the operating divisions, will continue to conduct random sample reviews of interim guidance for FOIA compliance. As resources permit, the IRS will consider the appropriateness of a more formalized program for monitoring and measuring compliance rates.

The IRS is committed to improving the decision-making process through tools and training. For example, a tool exists to aid authors to determine if information belongs in the IRM. If the content is determined to be guidance or procedural instructions, the author is advised to include the issue in the IRM. Alternately, the author may issue it as interim guidance. In addition, the SERP IPU process has a built-in process that mandates the use of E-FOIA decision-making tool. The IRS will continue to evaluate our decision-making tools and welcomes suggestions for improvement.

The IRS supports technical training on E-FOIA compliance to interim guidance authors. Virtual training is available and offered to employees with responsibilities to evaluate content for disclosure. In FY 2011, more than 200 employees attended classes on E-FOIA. Authoring "instructions to staff" is a collateral duty and this responsibility may be reassigned. To ensure that employees with these responsibilities have proper training, the Office of SPDER is developing web-based training on topics, including E-FOIA and clearance, related to managing "instructions to staff." Due to budget constraints, training and travel funds must be prioritized.

Frequently Asked Questions posted on IRS.gov should also adhere to the clearance and approval requirements per IRM 2.25.101.4.2, *IRS.gov Content Management Guidelines*. The IRS agrees that FAQs, not based on established policy and procedures, but designed to guide staff in how to administer a law or regulation that affects the public, should follow the established policies and procedures for "instructions to staff."

As discussed, functional specifications are based upon established policy and law that are already available to the public. In the rare case that programming reflects a procedure or policy that is not publically available, changes are made as appropriate.

In conclusion, the IRS demonstrates our commitment to accountability and transparency. We continually strive to administer the FOIA in favor of disclosure.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate commends the IRS for (1) working with TAS to update its guidance regarding clearance and disclosure of IGM and IPU's, (2) adopting many of TAS's suggestions for improving the SERP and SPDER E-FOIA decision making tools, (3) offering virtual training to employees, (4) working to develop web-based training, (5) sampling IGM and SERP IPU's issued between July 1, 2010, through June 30, 2011, to determine if they were properly categorized and disclosed, (6) committing to conduct random sample reviews of interim guidance for FOIA compliance, provided funding is available, and (7) establishing a procedure to help prevent the IRS from using the SERP alert process (rather than the IPU or IGM process) to change IRM content.

The National Taxpayer Advocate also commends the IRS for training 200 employees on E-FOIA. As noted above, however, there are about 646 IRM authors whose duties may change or who may change jobs. Moreover, the IRS's interpretation of the E-FOIA requirements has been evolving and it has repeatedly revised its decision support tools. Thus, it is important for all IMD authors to receive consistent E-FOIA training based on the IRS's most current interpretation of the law. Such training does not need to be expensive. The IRS could deliver training through web-based systems, which would eliminate any barriers to making this training mandatory for guidance authors.

In addition, the National Taxpayer Advocate commends the IRS for being responsive to many of the concerns expressed by TAS during the preparation of this report. It revised the E-FOIA decision-making tools several times – most recently after the last revision of the Most Serious Problem (MSP) discussion (above) was finalized. After TAS formally requested data on the accuracy of disclosure determinations regarding IGM and IPU's, the IRS conducted a sample.<sup>81</sup> After TAS expressed concern that the IRS sometimes used SERP alerts to modify the IRM, the IRS established a process to help address the problem. The National Taxpayer Advocate hopes that the IRS's responsiveness to transparency concerns continues.

However, certain statements in the IRS comments require clarification. First, the IRS response states that interim guidance is typically posted within 14 days of issuance. The IRS does not cite any data to support this assertion, but we understand it is from internal reports compiled by SPDER. Moreover, the IRS has indicated that it does not track the accuracy of interim guidance disclosure determinations.<sup>82</sup> Thus, the IRS appears to have no way of knowing if this statement is correct – some guidance may not be posted.

<sup>81</sup> TAS information request (May 31, 2011) ("Who is responsible for measuring the overall accuracy of E-FOIA determinations (*i.e.*, whether the proper disclosure determination was made) for SERP Alerts, SERP IPU's, and IG Memos? If available, please provide E-FOIA accuracy data for the past three fiscal years."); Response to TAS information request (June 24, 2011) ("Accuracy data are not available."). However, the IRS did not update its response once such data became available or inform TAS that it was conducting a sample.

<sup>82</sup> Response to TAS information request (June 24, 2011).

Second, the IRS response states that “current practices” are “fully compliant” with FOIA. However, the IRS’s recent statistical sample of IGMs and SERP IPU’s (described in the IRS comments), suggest that its current practices may result in mischaracterization and potential violations of the law up to seven percent of the time.<sup>83</sup> Moreover, the body of the MSP describes several instances where the IRS may have violated the law by failing to timely post items to the ERR on IRS.gov. Thus, we disagree with the suggestion that the IRS’s “current practices” are “fully compliant.”

Third, the IRS response states: “When issues are identified with respect to the IRS’ overall compliance with FOIA, the IRS takes actions as appropriate.” In fact, the IRS declined to disclose its “secret” March 1 memo (addressing OVDP FAQ #35, as described above) after TAS alerted the IRS that it should have been disclosed. TAS alerted the IRS on several occasions, including March 17, 2011, but the IRS waited until after the National Taxpayer Advocate issued a Taxpayer Advocate Directive (TAD) on August 16, 2011, which formally elevated the matter to the operating division Commissioner level, before finally agreeing to do so.<sup>84</sup> Thus, while the IRS did *eventually* take “appropriate action,” this example suggests that the IRS may not always take timely action on its own.

Fourth, the IRS comments suggest that TAS’s analysis of the E-FOIA decision tool is obsolete because it revised the tool after TAS finalized the body of the MSP. While subsequent revisions to the tool did address many of TAS’s concerns, they did not address one important concern. In contrast to the tool, the statutory language is very broad, simple, and clear. It requires disclosure of all “instructions to staff that affect a member of the public,” unless an exemption applies.<sup>85</sup> Yet, as of this writing, the current version of the tool requires disclosure only if the instructions affect “how a member of the public files, pays, complies with their tax requirements or interacts with the Service.”<sup>86</sup> Thus, the tool remains narrower and more complicated than the statutory language.

Fifth, the IRS comments suggest that FAQs are subject to a clearance and approval process that is set forth in IRM 2.25.101.4.2. This statement could be misinterpreted. IRM 2.25.101.4.2 discusses in general terms that changes to certain portions of the IRS website require approval by the IRS’s Communications and Liaison function. It does not reference or address a clearance process applicable to FAQs. As the IRS has previously

<sup>83</sup> If 96.1 percent were correctly categorized with a 3 percent margin of error, then up to 6.9 percent ( $100 - 96.1 = 3.9$ ;  $3.9 + 3 = 6.9$ ) may have been incorrectly categorized. Even if the IRS’s sample is statistically valid, TAS has questions about its analysis: How was the sample identified? What criteria was used to evaluate it (e.g., which version of the E-FOIA tool, the IRM, or the law)? Given the IRS’s evolving interpretation of the law, even if the law were the benchmark, which interpretation of the law was used? Who were the reviewers and what knowledge did they have about the substantive subject matter and the FOIA law? How many taxpayers were affected by the guidance that was mischaracterized or improperly withheld?

<sup>84</sup> E-mail from TAS to Disclosure (Mar. 17, 2011); Taxpayer Advocate Directive 2011-1 (*Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and comply with the Freedom of Information Act*) (Aug. 16, 2011), available at <http://www.irs.gov/advocate/article/0,,id=251887,00.html>.

<sup>85</sup> See 5 U.S.C. § 552(a)(2)(C).

<sup>86</sup> The IRS comments also suggest that the TAS report overlooked the “interacts with the Service” portion of the revised tool. TAS did not. The charts above accurately reflect the July 12, 2011, versions of the tools. As shown above, the SERP tool did not include the “interacts” language. The SPDER tool included the language in the definitions section. Moreover, we footnoted the subsequent change to the tools, indicating that the changes did not fully address our concerns.

acknowledged, “SPDER is not responsible for providing guidance on clearing and disclosing these documents.”<sup>87</sup> Thus, FAQs are not subject to the normal clearance process that applies to other instructions to staff.

Finally, the IRS comments state:

Programming is based on procedures and processes available to the public. In the event the IRS learns that programming reflects a procedure or policy not available to the public, changes are made accordingly so that appropriate transparency exists.

The National Taxpayer Advocate has identified in two separate reports to Congress the IRS’s failure to disclose the policies and procedures that are incorporated into the programming used by the Reasonable Cause Assistant.<sup>88</sup> However, the IRS has still not disclosed the specific policies and procedures that it uses. Moreover, the IRS incorporates policies and procedures into computer programming on a regular basis and these policies sometimes affect the public, but none are posted to the ERR. Thus, we do not agree that when the IRS learns that programming reflects a procedure or policy that is not available to the public, it takes appropriate steps to ensure that transparency exists.

However, the IRS could address the problems associated with undisclosed functional specifications and uncleared FAQs by requiring the authors of FAQ and functional specifications to use a decision-tree analysis tool, just like authors issuing IPU. The tool could help identify those items that should go through a clearance process and/or be incorporated into the IRM.

## Recommendations

The National Taxpayer Advocate recommends that the IRS:

1. Assign one office the responsibility to measure and improve the accuracy of IRS E-FOIA and clearance determinations.
2. Require all authors of FAQs, functional specifications, job aids, desk guides, SERP alerts, and IMD to attend E-FOIA training.
3. Continue efforts to improve internal SERP and SPDER E-FOIA decision-making tools.
4. Require employees submitting SERP alerts to use a decision-making tool to determine if the alert should be disclosed.

<sup>87</sup> Response to TAS information request (June 24, 2011).

<sup>88</sup> National Taxpayer Advocate 2010 Annual Report to Congress 71-84 (Most Serious Problem: *IRS Policy Implementation Through Systems Programming Lacks Transparency and Precludes Adequate Review*).

5. Implement tentative plans to establish a transparent process for periodically selecting a random sample of IMD, job aids, desk guides, local procedures, and SERP alerts (and other internal communications, if practical) to identify the magnitude and source of the IRS's E-FOIA compliance challenges and post the results on the IRS website.
6. Establish a process for clearing FAQs and similar items posted on IRS.gov;
7. Establish a process for disclosing functional specifications that are equivalent to instructions to staff that would have to be disclosed.
8. Create new E-FOIA decision-making tools, or expand the existing tools, to assist authors of FAQs and functional specifications determine when items need to be cleared and/or incorporated into the IRM.

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

Beth Tucker, Deputy Commissioner for Operations Support  
Jodi Patterson, Director, Return Integrity and Correspondence Services

**DEFINITION OF PROBLEM**

In light of the recent significant decline in the market for refund anticipation loans (RALs), the IRS is properly positioned to protect the best interests of taxpayers as the commercial refund delivery product market continues to evolve. Taxpayer demand for a quick refund turnaround time will always exist, and as the market for one refund delivery product disappears, the markets for other products may expand or new ones may develop. With the implementation of the Customer Account Data Engine 2 (CADE 2), the IRS has the opportunity to make significant strides in meeting taxpayer demand by reducing refund processing times by an average of five days, but the agency should also focus on monitoring the evolving commercial market targeting unbanked and low income taxpayers.<sup>1</sup> Due to the impact commercial refund products have on tax compliance, it is in the best interest of tax administration to take a proactive oversight stance in this market.<sup>2</sup>

The IRS took an aggressive and much-needed step when it stopped providing the Debt Indicator to preparers and their associated financial institutions. The result of this decision was a sharp decline in the RAL market. However, the IRS should continue to protect taxpayers as the market evolves, as provided below:

- While the “Where’s My Refund” service benefits taxpayers by providing refund delivery and offset information, the IRS could better serve taxpayers by providing more accurate information regarding delays in refund processing due to compliance initiatives.
- The IRS is not aggressive enough in educating taxpayers about refund delivery options, including information about average turnaround times for lower cost and government-sponsored options. With the 2012 rollout of CADE 2, the IRS will be able to process returns five days quicker and refund turnaround times will be faster, which may impact taxpayers’ choices if the IRS provides clear and complete information.

<sup>1</sup> IRS, CADE 2 Overview Briefing 17 (Sept. 2011). Based on a 2009 FDIC survey, an estimated 7.7 percent of U.S. households, approximately nine million, are unbanked. At least 17 million adults reside in these unbanked households. In addition, an estimated 17.9 percent of U.S. households, roughly 21 million, are underbanked (households with checking or savings accounts, but still use alternative financial services, such as check cashing services and payday loans). Federal Deposit Insurance Corporation, *FDIC National Survey of Unbanked and Underbanked Households*, Executive Summary 3 (Dec. 2009).

<sup>2</sup> The use of commercial refund delivery products has been linked to noncompliance. Karen Masken, Mark Mazur, Joanne Meikle, and Roy Nord, IRS Office of Research, Analysis, and Statistics, *Do Products Offering Expedited Refunds Increase Income Tax Non-Compliance?*, Proceedings of the 101st Annual Conference on Taxation (June 1, 2008).

- While the IRS has partnered with several financial institutions to offer refunds on debit cards offered by Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) organizations, it claims it does not endorse any particular product. However, the IRS provides volunteer sites with CCH's TaxWise software free of charge. TaxWise incorporates a Western Union debit card product into the free software, and the terms associated with this particular product appear less favorable than for the other products.<sup>3</sup>
- The Treasury Department launched a debit card pilot program during the 2011 filing season to issue refunds via prepaid cards to up to 800,000 unbanked taxpayers.<sup>4</sup> The pilot was a necessary step to address the needs of the unbanked. After analyzing the preliminary results of the pilot, Treasury decided to discontinue the program due to low participation rates.<sup>5</sup> Despite low participation in the pilot as designed, the National Taxpayer Advocate believes it is in the best interest of taxpayers and tax administration to make a government-sponsored debit card available on a nationwide basis. Thus, the IRS should evaluate the methodology of the pilot, with a particular focus on the marketing campaign, to develop a more effective marketing strategy for a future government-sponsored debit card program.
- Taxpayers' demand for commercial products will remain high as long as they struggle to pay for return preparation fees before they receive their refunds. The IRS can address this need by evaluating the feasibility of enabling taxpayers to pay their return preparation fees through the split refund program, which provides convenience but will require strict safeguards to reduce risks of preparer-perpetrated fraud.
- Through revisions to Circular 230, Treasury and the IRS can leverage the return preparer program to ensure that taxpayers are better informed about their refund delivery options. Treasury and IRS should require preparers to clearly communicate the timeframes and costs associated with refund delivery options, with a particular emphasis on the lower cost and government-provided options.

## ANALYSIS OF PROBLEM

### Background

#### *Taxpayers Have Several Refund Delivery Options.*

Taxpayers have various refund delivery options, of which the most popular is a direct deposit into the taxpayer's bank account. When combined with e-filing, this method will get

<sup>3</sup> Western Union, *Tax Refund Prepaid Card Solution For: TaxWise*, available at <http://tax-coalition.org/program-tools/financial-services/asset-building/asset-building-products/debit-cards/western-union-moneywise-card/western-union-moneywise-card> (last visited Oct. 4, 2011); Government Accountability Office (GAO), GAO-11-481, *2011 Tax Filing: IRS Dealt with Challenges to Date but Needs Additional Authority to Verify Compliance* 38 (Mar. 2011).

<sup>4</sup> Treasury also launched a companion pilot to encourage tens of thousands of current and potential payroll card users to direct deposit their 2010 federal tax refund onto existing payroll cards.

<sup>5</sup> Eric Kroh, *Treasury Won't Renew Debit Card Refund Program in 2012, Spokesman Confirms*, Tax Notes Today (Nov. 1, 2011).

a refund into the taxpayer's account in as few as ten days at no cost,<sup>6</sup> but it is not available to unbanked taxpayers. These taxpayers can choose to receive a paper check, which takes up to six weeks and may involve check cashing fees, or purchase a commercial product that may reduce the wait but typically involves high fees. Such commercial products include RALs, refund anticipation checks (RACs), and debit cards.<sup>7</sup>

*Commercial Refund Delivery Products May Harm Taxpayers and Tax Administration.*

The National Taxpayer Advocate has been raising concerns regarding various commercial refund products, RALs in particular, for several years.<sup>8</sup> These concerns include:

- Taxpayers incur high fees charged by financial institutions as well as the paid preparers who facilitate the sale of these products;
- Banks provide financial incentives to paid preparers who facilitate the sale of these products and create an opportunity for preparers to benefit by artificially inflating refund amounts;<sup>9</sup> and
- While a real demand for quick refunds exists, many taxpayers are not aware that they can avoid associated high fees if they wait just a few more days and receive a direct deposit from the IRS. The IRS is not taking a proactive role in educating taxpayers by clearly conveying all refund delivery options, the associated fees, and the average refund turnaround times for each.<sup>10</sup>

A study performed by the IRS Office of Research, Analysis, and Statistics supports these concerns. The study found that taxpayers' use of bank products such as RALs and RACs may have detrimental effects on tax administration. In particular, taxpayers who used RALs were found to be less compliant than others who did not. Specifically, audits of RAL

<sup>6</sup> IRS, Tax Tip 2011-19, *Want Your Refund Fast – Choose Direct Deposit* (Jan. 27, 2011). As of June 3, 2011, over 76 million refunds were delivered by direct deposit out of a total of over 102 million refunds issued to individual taxpayers. The number of direct deposit refunds increased by 5.9 percent from the same time in 2010, as compared to only 0.9 percent in the total number of refunds. IRS Filing Season Statistics, June 3, 2011.

<sup>7</sup> RALs are loans secured by a taxpayer's anticipated tax refund. RACs are temporary bank accounts established on behalf of a taxpayer into which the IRS can direct deposit a refund and out of which a bank typically issues a payment to the taxpayer.

<sup>8</sup> National Taxpayer Advocate 2008 Annual Report to Congress 427; National Taxpayer Advocate Fiscal Year 2007 Objectives Report to Congress, *The Role of the IRS in the Refund Anticipation Loan Industry, Vol. II* (June 30, 2006); *Tax Return Preparation Options for Taxpayers: Hearing Before S. Comm. on Finance*, 109th Cong. (Apr. 4, 2006) 1-5 (statement of Nina E. Olson, National Taxpayer Advocate); National Taxpayer Advocate 2005 Annual Report to Congress 162-79; *Fraud in Income Tax Return Preparation: Hearing Before Subcomm. on Oversight, H. Comm. on Ways & Means*, 109th Cong. (July 20, 2005) (statement of Nina E. Olson, National Taxpayer Advocate).

<sup>9</sup> See Department of Treasury, Notice of Proposed Rulemaking, REG-136596-07, *Guidance Regarding Marketing of Refund Anticipation Loans (RALs) and Certain Other Products in Connection with the Preparation of a Tax Return* (2008); Karen Masken, Mark Mazur, Joanne Meikle, and Roy Nord, IRS Office of Research, Analysis, and Statistics, *Do Products Offering Expedited Refunds Increase Income Tax Non-Compliance?*, Proceedings of the 101st Annual Conference on Taxation (June 1, 2008).

<sup>10</sup> For example, at the start of the 2011 filing season, the IRS encouraged taxpayers to direct deposit and pointed out that "[t]axpayers can automatically get their money in as few as 10 days," but never compared the direct deposit option to other options. IRS, IR-2011-4, *IRS e-file Launches Today; Most Taxpayers Can File Immediately* (Jan. 14, 2011).

users resulted in a change in net tax liability 88 percent of the time compared to the 76 percent for taxpayers who did not use a bank product.<sup>11</sup>

***The IRS Significantly Impacted the RAL Market When it Eliminated the Debt Indicator.***

In August 2010, the IRS stopped providing the Debt Indicator (DI) to tax preparers and their financial institutions. The DI was a service created in the early 1990s to encourage tax preparers to file electronically by indicating in the filed tax return's acknowledgment file whether a taxpayer's anticipated refund would be offset to satisfy certain debts to federal or state agencies under the Treasury Offset Program (TOP).<sup>12</sup> Now that the e-file rate is approaching 80 percent, the IRS no longer needs to provide this incentive.<sup>13</sup> After this development, RALs became much more risky ventures for the banks, because they were less certain whether the IRS would release the entire refund. The first bank to leave the market was JPMorgan Chase, one of the three largest RAL lenders. Subsequent actions taken by Office of Thrift Supervision, Office of Comptroller, and the FDIC led the remaining financial institutions to swiftly exit the RAL market.<sup>14</sup> Thus, taxpayers will no longer have the option of receiving their refunds through RAL products. This is a significant development, and the National Taxpayer Advocate commends the IRS and oversight agencies for taking the steps necessary to protect taxpayers from the high fees and other drawbacks associated with these products.

The commercial tax preparation firms and financial institutions that previously offered RALs lost revenues as a result of the government intervention. For example, H&R Block reported \$146.2 million in loan participation revenues in 2010. This number dropped to \$17.2 million in 2011. At the same time, fees earned from RACs increased \$94.1 million,

<sup>11</sup> The percentage of audit adjustments was 81 percent for RAC users as compared to 76 percent of taxpayers with no bank product. Interestingly, the use of a paid preparer did not impact compliance in the studied group. Finally, while the study found a higher incidence of noncompliance, it did not prove a causal relationship between RALs and noncompliance. Karen Masken, Mark Mazur, Joanne Meikle, and Roy Nord, IRS Office of Research, Analysis, and Statistics, *Do Products Offering Expedited Refunds Increase Income Tax Non-Compliance?*, Proceedings of the 101st Annual Conference on Taxation, Table 7 (June 1, 2008).

<sup>12</sup> The government's Financial Management Service (FMS) uses the TOP to manage liabilities owed by taxpayers to federal or state agencies and has statutory authority to offset federal income tax refunds against such debts. IRC § 6402(d). The acknowledgement file is a report generated by the IRS to the transmitter of electronically filed returns indicating whether transmitted returns were accepted or rejected by the IRS. For rejected returns, the report includes error codes. It also previously indicated if any claimed refunds were subject to offset.

<sup>13</sup> As of October 21, 2011, approximately 78 percent of individual returns were electronically filed in filing season 2011. Most e-filed returns are filed by October and any remaining returns filed during 2011 would be paper documents, so complete calendar year figures could show a slightly smaller percentage of e-filed returns. IRS, 2011 Filing Season Data – Return/Refunds, For Week Ending: 10/21/2011. IRS, *IRS Removes Debt Indicator for 2011 Tax Filing Season*, IR-2010-89 (Aug. 5, 2010); Sandra Block, *IRS Rule to End Release of Debt Info Threatens Refund-Anticipation Loans*, USA Today (Aug. 6, 2010). Preparers who e-file a client's tax return receive in the acknowledgment file an indication of whether an individual taxpayer will have any portion of the refund offset for delinquent tax or other debts, such as unpaid child support or delinquent federally funded student loans.

<sup>14</sup> The Office of Thrift Supervision prohibited MetaBank, a potential new entrant into the RAL market, from making the loans and the Office of Comptroller issued a regulatory directive against HSBC (H&R Block's RAL partner bank) prohibiting it from making RALs. Subsequently, the FDIC notified the banks under its oversight that the making of RALs without the Debt Indicator is "unsafe and unsound." In May 2011, the FDIC initiated action against the last of the RAL lenders, Republic Bank & Trust (Jackson Hewitt's RAL partner bank) and issued an Amended Notice of Charges for an Order to Cease and Desist with a proposed \$2 million civil money penalty. Office of Thrift Supervision, *In the Matter of Metabank, Order to Cease and Desist*, Order No. CN 11-25 (Eff. July 15, 2011); FDIC, *Amended Notice of Charges for an Order to Cease and Desist; Notice of Assessment of Civil Money Penalties, Findings of Fact and Conclusions of Law; Order to Pay; and Notice of Hearing: Republic Bank & Trust Company, Louisville, KY*; FDIC-10-079b; FDIC-10-216k (May 3, 2011).

or 107.5 percent, between 2010 and 2011, which the company attributed as increased client demand for a RAL alternative.<sup>15</sup> While tax preparers may have successfully steered their clients to remaining commercial refund delivery products, it is only a matter of time before the market evolves and develops new products, especially ones targeting former RAL purchasers.

### **The IRS Continues to Pass Debt Indicator Information to the Taxpayer but Should Further Enhance the Service.**

While the IRS stopped releasing the DI through the acknowledgement file in 2010, the DI information is still available to taxpayers in the “Where’s My Refund” application. This information helps taxpayers estimate how much of their anticipated refund they will actually receive. The IRS continually improves this program and currently provides taxpayers with the date it will release such refund. The National Taxpayer Advocate believes the program should provide taxpayers with as complete information as possible, especially regarding delays in refund processing due to compliance initiatives.<sup>16</sup>

In the long run, the IRS could provide extremely beneficial service to the taxpayer if it designs the “Where’s My Refund” program to inform taxpayers that their return does not match third-party data. To give the program this capability, the IRS would need to overhaul its information return processing system to allow it to match documents before releasing refunds. Taxpayers would benefit by being able to correct the error early in the process and would avoid the accrual of interest and penalties.<sup>17</sup>

### **CADE 2 Has the Capacity to Meet Taxpayer Needs by Shortening Refunds but the IRS Needs to Be More Aggressive in Educating Taxpayers About Its Benefits.**

In 1999, the IRS initiated its current Customer Account Data Engine to provide a modernized system to process returns. Among the many benefits of CADE 2 (the revised version of CADE), the program allows the IRS daily processing capabilities (instead of weekly), which will translate into faster return processing and more timely account information.<sup>18</sup> Thus, the IRS can release refunds processed through CADE 2 on average five days earlier than if the returns had been processed through the Individual Master File.<sup>19</sup>

We commend the IRS for these efforts. However, to ensure that taxpayers are aware of the reduced processing times, starting in 2012, the IRS should run a marketing campaign at the beginning of every filing season providing details on average processing and refund

<sup>15</sup> H&R Block, 2011 Form 10-K, Fiscal Year Ending April 20, 2011, Item 7 at 20.

<sup>16</sup> In the 2008 annual report, the National Taxpayer Advocate made a legislative recommendation that the IRS include a Revenue Protection Indicator with compliance information in the “Where’s My Refund?” Program. National Taxpayer Advocate 2008 Annual Report to Congress 427-441.

<sup>17</sup> See Most Serious Problem: *Accelerated Third-Party Information Reporting and Pre-Populated Returns Would Reduce Taxpayer Burden and Benefit Tax Administration But Taxpayer Protections Must Be Addressed, infra.*

<sup>18</sup> The IRS will be able to process refunds within four days of receipt under CADE 2. IRS, *CADE 2 Overview Briefing 22* (Sept. 2011). GAO GAO-11-481, *2011 Tax Filing: IRS Dealt with Challenges to Date but Needs Additional Authority to Verify Compliance 3* (Mar. 2011).

<sup>19</sup> The IRS will be able to process refunds within four days of receipt under CADE 2. IRS, *CADE 2 Overview Briefing 9, 22* (Sept. 2011).

turnaround times for different delivery options, and advise taxpayers to inquire about commercial product fees.

### **The IRS Is Not Taking a Proactive Role in the Debit Card Market to Protect Taxpayers.**

It is unclear how the commercial market for refund products will evolve following the decline in the RAL market. However, one product that continues to see high demand is the debit card — both commercial and government-issued.<sup>20</sup> Debit card programs, especially when government-sponsored, have the potential to benefit both tax administration and taxpayers. Unbanked taxpayers benefit by receiving refunds quicker than paper checks and, with the right terms, will not incur high fees. The government benefits by reducing the number and cost of paper checks. These programs also improve the financial literacy of taxpayers by providing the unbanked with access to an ongoing financial account to obtain banking services.<sup>21</sup>

The federal government, *outside of the tax system*, directly participates in the debit card market. It has offered cards as a way to receive benefits since 2008, and the Department of Treasury now requires all federal benefits and *nontax* payments to be made electronically.<sup>22</sup> The purpose of the requirement is to provide a safer, more convenient and cost-effective way for people to get federal benefits.<sup>23</sup> While the use of direct deposit into a bank account is the ideal method, Treasury is encouraging unbanked benefit recipients to apply for the Direct Express Debit MasterCard, which has been available on a nationwide basis to Social Security recipients since 2008 and piloted on a local basis since 2006. As of December 2010, more than 1.5 million beneficiaries had signed up for the program.<sup>24</sup>

The IRS has taken a less proactive approach in the debit card market. Since 2009, a small number of VITA sites encouraged unbanked taxpayers to obtain a debit card sponsored by a participating financial institution. In 2010, the IRS worked with several large institutions to offer debit cards at 20 VITA sites. In the 2011 filing season, almost all of the roughly

<sup>20</sup> Debit cards are also known as prepaid cards and stored value cards. For more information on debit cards, see <http://www.nbpc.org/en/What-Are-Prepaid-Cards.aspx> (last visited July 24, 2011).

<sup>21</sup> GAO, GAO-11-481, *2011 Tax Filing: IRS Dealt with Challenges to Date but Needs Additional Authority to Verify Compliance* 4 (Mar. 31, 2011).

<sup>22</sup> Individuals who apply for nontax benefits after May 1, 2011 must choose an electronic payment option upon enrollment. All paper check recipients who applied for benefits before May 1, 2011 are required to switch from paper checks to electronic payments by March 1, 2013. 31 C.F.R. § 208. See also 31 U.S.C §§ 3332, 3336.

<sup>23</sup> Department of Treasury, *Electronic Payment Rule (31 C.F.R. § 208) Frequently Asked Questions*, available at [http://waysandmeans.house.gov/UploadedFiles/Congressional\\_FAQs\\_Final\\_2010.doc](http://waysandmeans.house.gov/UploadedFiles/Congressional_FAQs_Final_2010.doc) (last visited July 19, 2011).

<sup>24</sup> In December 2006, the Social Security Administration (SSA) launched a pilot program offering a debit card to 35,000 Old-Age, Survivors, and Disability Insurance (OASDI) and Supplemental Security Income (SSI) paper check recipients in Illinois. Based on the results of the pilot, the program went national in June 2008. FMS, U.S. Dept. of Treasury, *Treasury Extends Direct Deposit to Millions of Americans, Phasing out Paper Checks for Benefit Payments* (Dec. 21, 2010). In a 2009 survey, 95 percent of Direct Express cardholders expressed satisfaction with the card. Dept. of Treasury and Federal Reserve Bank, Go Direct Campaign, *Direct Express Satisfaction Survey*, KRC Research (July 2009).

12,000 VITA and Tax Counseling for the Elderly sites offered debit cards.<sup>25</sup> Despite its efforts to provide these no-cost and user-friendly debit cards to taxpayers, the IRS claims it does not endorse any financial product at volunteer sites. In addition, IRS employees working at these sites cannot offer any of these products to taxpayers.<sup>26</sup>

However, while the IRS may not directly endorse any particular commercial product, it provides the VITA and TCE sites with free CCH TaxWise preparation software, which has fully integrated the Western Union MoneyWise prepaid card. Moreover, CCH sends marketing materials with TaxWise, and the software lists the card as a refund delivery option. While the IRS does not require VITA sites to stock the prepaid cards, the IRS's provision of this software free of charge to VITA/TCE sites has certainly set the stage for TaxWise to market its affiliated products to the VITA/TCE organizations with a clear advantage over competitor products.<sup>27</sup> In addition, because volunteer sites can choose from a wide variety of programs, and there is no government-sponsored product available yet, the terms and fees associated with various options confuse taxpayers.<sup>28</sup>

In her 2008 Annual Report, the National Taxpayer Advocate recommended that Treasury develop a program to enable unbanked taxpayers to receive tax refunds on stored value cards (SVCs) or debit cards. Treasury began pilot testing a program in the 2011 filing season that offered tax refunds on debit cards to low income taxpayers.<sup>29</sup> Treasury mailed offers to approximately 808,000 taxpayers who likely made less than \$35,000 per year and were unlikely to have bank accounts. Taxpayers received cards on a Visa debit card platform from a contractor selected by Treasury, and randomly assigned one of eight offers to each recipient to test how they would respond to different offers. The offers vary by monthly fee (either no fee or \$4.95), whether the card has access to a savings account, and the promotion message (either convenience or safety). Treasury expected a low take-up rate for the pilot, as with most direct mailing campaigns, and it contracted with the Urban Institute to evaluate the program.<sup>30</sup> Unfortunately, Treasury decided to terminate the pilot and will not offer the cards during the 2012 filing season. Low participation was the reason

<sup>25</sup> GAO, GAO-11-481, *2011 Tax Filing: IRS Dealt with Challenges to Date but Needs Additional Authority to Verify Compliance* 31 (Mar. 2011). For filing season 2011, the IRS worked with JP Morgan Chase, PNC Bank, U.S. Bank, and Western Union. Debit cards from Western Union are available through the VITA return preparation software. The other three banks offer debit cards at a limited number of VITA sites. None of the cards includes a monthly or activation fee, but may involve ATM fees. In addition, VITA partner organizations work with local banks to provide debit cards.

<sup>26</sup> IRS, *Fact Sheet: Offering Financial Products at VITA/TCE Sites* (Jan. 2011).

<sup>27</sup> Western Union, *Tax Refund Prepaid Card Solution For: TaxWise*, available at <http://tax-coalition.org/program-tools/financial-services/asset-building/asset-building-products/debit-cards/western-union-moneywise-card/western-union-moneywise-card> (last visited Oct. 4, 2011).

<sup>28</sup> For a list of the various fees charged by the debit cards offered at VITA/TCE sites, see GAO, GAO-11-481, *2011 Tax Filing: IRS Dealt with Challenges to Date but Needs Additional Authority to Verify Compliance* 38 (Mar. 2011). For example, all of the programs have such favorable terms as free activation and monthly maintenance on all programs. However, the Western Union program seemed to have the highest transactional fees, with \$1.95 per ATM withdrawal fees, \$4.95 cash reload fees, and no relationship building with any financial institution.

<sup>29</sup> National Taxpayer Advocate 2008 Annual Report to Congress 427-441.

<sup>30</sup> GAO, GAO-11-481, *2011 Tax Filing: IRS Dealt with Challenges to Date but Needs Additional Authority to Verify Compliance* 17, 39 (Mar. 31, 2011); *Hearing on Financial Literacy: Empowering Americans to Make Informed Financial Decisions, Subcomm. on Oversight of Government Management, the Federal Workforce, and the District of Columbia, S. Comm. on Homeland Security and Governmental Affairs*, 112th Cong. (Apr. 12, 2011) (testimony of Acting Director Joshua Wright Office of Financial Education and Financial Access U.S. Department of the Treasury).

given for the decision — only 2,000 of the 800,000 people offered the cards in 2011 chose to use them.<sup>31</sup>

Without a nationally available government-sponsored card for taxpayers to use for their tax refunds, the IRS will continue to be at the mercy of the commercial debit card industry with respect to the electronic delivery of refunds to unbanked taxpayers. The IRS can do a better job at negotiating more favorable terms on various commercial programs made available to low income taxpayers, but it does not have the authority to regulate the providers of these commercial cards or require that all tax payments be made electronically. The recent Treasury pilot was an important first step in having the federal government take a more proactive role in this area as it has in other benefit payment areas. We are disappointed that Treasury ended the pilot due to low participation. However, we believe the IRS should evaluate the methodology of the pilot, with a particular focus on the marketing campaign, to determine a more effective marketing strategy for a future government-sponsored debit card program. In the meantime, the IRS can protect taxpayers by conducting a public awareness campaign to educate taxpayers about the information they should request before buying commercial debit cards.

**The IRS Will Better Serve Taxpayers by Providing a Method with Appropriate Safeguards to Split Refunds for Payment of Return Preparation Fees.**

A main reason taxpayers purchased RACs and RALs was to have a way to pay for tax preparation fees before the IRS released the refund.<sup>32</sup> Now that the RAL is no longer a real option, some taxpayers may struggle to pay preparer fees before they receive their refunds. When the IRS announced it was terminating the DI, it indicated that it would evaluate the possibility of providing taxpayers with a way to pay for preparation through the split refund program.<sup>33</sup> While this option would address the needs of taxpayers, it is certainly not without real risk to taxpayers and tax administration.

The most significant risk is that this initiative could facilitate preparer fraud. The IRS and TAS are currently receiving cases where the preparer prepares a return and tells the client he or she is due a refund of a certain amount. The preparer provides the taxpayer with a copy of what the taxpayer believes is the return the preparer will file, but the preparer later changes the return by increasing the size of the refund. The preparer then splits the refund, with the initial amount deposited into the taxpayer's bank account and the additional, fraudulent amount deposited into the preparer's account (making it appear as if the taxpayer owns the account).<sup>34</sup> If the IRS launches this proposed refund-splitting program

<sup>31</sup> Eric Kroh, *Treasury Won't Renew Debit Card Refund Program in 2012, Spokesman Confirms*, Tax Notes Today (Nov. 1, 2011).

<sup>32</sup> Urban Institute, *Who Needs Credit at Tax Time and Why: A Look at Refund Anticipation Loans and Refund Anticipation Checks: Briefing for the U.S. Department of the Treasury*, Slide 17 (Oct. 21, 2010).

<sup>33</sup> IRS, *IRS Removes Debt Indicator for 2011 Tax Filing Season*, IR-2010-89 (Aug. 5, 2010) ("In a related effort, the IRS plans to explore the possibility of providing a new tool for the 2012 tax filing season to give taxpayers a mechanism to use an appropriate portion of their tax refund to pay for the services of a professional tax return preparer.").

<sup>34</sup> See Taxpayer Advocate Service, *Interim Guidance on Recognizing and Assisting Victims of Return Preparer Theft* (Mar. 14, 2011).

without any safeguards, it may increase the opportunity for this type of fraud. An efficient and effective safeguard is a duly educated taxpayer, who can protect him- or herself from harm, first by choosing an honest preparer, and second by retaining copies of his or her unaltered returns with the preparer's signature and PTIN showing the amount of refund due.<sup>35</sup>

IRC § 6695(f) imposes a \$500 penalty on a preparer who negotiates a tax refund check or electronic payment issued to the taxpayer and deposits the money into the preparer's account. A refund splitting arrangement would work best if Congress amended the provision to permit refund splitting and impose the \$500 penalty when the preparer violates the rules. Because of the resulting increased risk of return preparer fraud, Congress should consider increasing the penalty amount to the greater of 100 percent of the amount misappropriated or \$500. Second, the Anti-Assignment Act may prevent the IRS from issuing a check or payment to an account not owned by the taxpayer.<sup>36</sup>

If the IRS and Treasury overcome the security and legal hurdles, taxpayers would benefit from having the following safeguards built into the program:

1. The IRS should require that the preparer enter his or her PTIN on Form 8888, *Allocation of Refund (Including Savings Bond Purchases)*, in the space dedicated to splitting the refund to pay for preparation fees. This requirement would also benefit the IRS Return Preparer Program by encouraging preparers to obtain their PTINs if they want to receive payment for their services. In addition, it would enable the IRS to track preparation fees.<sup>37</sup> To be effective, however, the IRS must validate the PTINs entered on the form.
2. The IRS should require preparers to explain the split refund process and include a checkbox on Form 8888 where the taxpayer will indicate awareness that the preparer will receive part of the refund deposited into his or her account to pay return preparation and filing fees.

### **The IRS Should Proactively Regulate the Marketing of Products by Preparers.**

Finally, as the IRS recently launched a program to regulate return preparers, it is positioned to take a proactive oversight role in the marketing of refund delivery products by preparers. It can accomplish this by setting forth the appropriate standards in Circular 230 § 10.34, *Standards with respect to tax returns and documents, affidavits and other papers*. Such standards could require preparers to clearly communicate the options available for refund delivery, comparing them to lower-cost options, including those sponsored or provided directly by the federal government. The standards should require preparers to provide

<sup>35</sup> See Status Update: *The IRS Has Made Significant Progress in Developing and Implementing a System to Register and Test Return Preparers*, *infra*.

<sup>36</sup> See 31 U.S.C. 3727, 31 C.F.R. 240.

<sup>37</sup> By including this option and requiring the PTIN on Form 8888, the IRS could collect data on return preparation fees. The IRS can keep the data by preparer credential and geographic area and publish the data in the Statistics of Income. TAS could also publish the data in its Congressional Data Books. Thus, the IRS would not directly regulate fees, but would provide oversight through transparency.

accurate and updated information about the average time it takes the IRS to process returns, especially as IRS rolls out CADE 2, as well as the average length of time it takes the IRS to deliver a refund for private and government-sponsored refund options. Any reference to commercial products should clearly state the associated fees. Further, any preparer who steers clients to the higher-cost options without due regard to the lower cost options should face Circular 230 sanctions.<sup>38</sup> The IRS can ease the burden of this requirement on preparers by providing a plain-language information sheet that all preparers can use. Coupled with a consumer education marketing campaign, this approach arms the taxpayer consumer with the necessary information to make the best choice for him- or herself.

## CONCLUSION

While we believe the decline of the RAL market benefits taxpayers, we also acknowledge that taxpayers, especially the unbanked, will continue to search for a fast, low-cost refund delivery option. As the market evolves to meet this demand, it is in the taxpayers' and government's best interest that the IRS take a more proactive approach with respect to these products. Without the IRS taking such a role, private industry will compensate for the loss of the RAL market, possibly by developing other commercial products with high fees and potentially harmful consequences to taxpayers.

To assume a proactive role in the refund delivery market and protect taxpayers' interests, the National Taxpayer Advocate preliminarily recommends that the IRS:

1. Enhance "Where's My Refund" to include more detail about delays due to compliance initiatives;
2. Undertake an aggressive public awareness campaign educating taxpayers about the reduced return processing time as well as its impact on refund turnaround times for government-sponsored refund options. This campaign should also inform taxpayers about the questions they should ask before purchasing a commercial refund product, such as a debit card.
3. Require that CCH remove all references to the Western Union debit card product from the standard TaxWise software the IRS requires VITA/TCE sites to use, or negotiate terms for debit card services as part of its contracting for VITA/TCE tax preparation software;
4. Evaluate the possibility of providing taxpayers with the ability to assign a portion of refunds to preparer bank accounts as long as the IRS modifies Form 8888 to require the preparer to enter the PTIN and adds a checkbox indicating the taxpayer's awareness of the refund splitting arrangement;

<sup>38</sup> 31 C.F.R. § 10.50.

5. Partner with Treasury and the financial sector to offer a Treasury-sponsored debit card for tax refunds, and use the results of the Treasury debit card pilot to design a more desirable product and develop a more effective marketing strategy for the product; and
6. Take a more proactive role in the oversight of the commercial refund delivery products, including amending Circular 230 to require preparers to inform taxpayers about the costs and accurate timeframes associated with each refund delivery option, with associated sanctions for failure to do so, and developing an information sheet for use by preparers.

### IRS COMMENTS

The IRS is committed to providing taxpayers with sufficient information to make informed decisions on their filing, payment, and refund delivery options including electronic alternatives that speed up the delivery of refunds. Each filing season, the IRS delivers extensive communications and conducts outreach to explain the various options available to taxpayers. Key messages for the 2012 filing season include the following.

- Due to technology improvements, the IRS will issue refunds to more taxpayers in as few as ten days this year. In tax year 2010, IRS issued refunds to 98 percent of electronic filers by direct deposit within 14 days and issued refunds to 98 percent of all taxpayers in 21 days or less.<sup>39</sup>
- The IRS posts the refund cycle chart on IRS.gov in English and Spanish, providing very specific information about when a refund should be issued based on when the tax return is filed, whether it was filed electronically or on paper, and whether the refund is delivered by direct deposit or paper check. This information is shared with the tax professional and e-file industry.
- Even though the vast majority of returns are processed without delay, our communications will include reminders regarding the following:
  - How to submit a complete and accurate return,
  - What to expect if a return is selected for review, and
  - That taxpayers should be aware that many variables can affect the speed of a tax refund including the need to protect revenue and to ensure that claims are valid.

Communications will also provide information on filing, payment and refund options; how the refund process works; and the speed of refunds.

The IRS developed the “Where’s My Refund” application to provide an automated method for taxpayers to check the status of their refund. The application has the ability to provide information on many situations that impact the amount or timing of a refund including adjustments due to mathematical errors. The “Where’s My Refund” application does not

<sup>39</sup> Refund Cycle Times for E-filed and Paper Returns by Refund Type, Tax Year 2010 Through Cycle 30.

provide the debt indicator to taxpayers. It will provide a notice to taxpayers who owe a non-tax debt through the Financial Management Service's Treasury Offset Program (TOP) to let them know all or part of their refund may be offset prior to refund release. Once a TOP offset occurs and the offset record is received by the IRS, "Where's My Refund" provides the amount of the offset, as well as the amount of refund the taxpayer can expect to receive. In a small number of situations where the application cannot provide the taxpayer's specific refund information, taxpayers are able to call and speak to a live assistor about their account and refund status.

In 2009, IRS initiated a formal effort to collaborate with banks and Volunteer Income Tax Assistance sites to encourage taxpayers not requesting direct-deposit refunds to opt for a prepaid card sponsored by financial institutions. During the 2011 filing season a total of 4,746 sites (excluding AARP and military sites) offered prepaid cards. The IRS partnered with two different banks to offer prepaid cards at certain VITA sites, which allowed these sites the ability to offer multiple prepaid cards. All VITA sites had the prepaid card option available through the tax preparation software TaxWise. The IRS offers this commercial off-the-shelf tax preparation software to electronically prepare and transmit taxpayer returns. At the time the IRS entered into the software contract with TaxWise, it did not include this debit card feature. Although it is available to all VITA/TCE sites, the particular debit card offered through the software is not required and many sites do not offer this exclusive debit card option. We will continue to evaluate options for the future related to this issue.

With regard to Refund Anticipation Loans, the IRS shares the National Taxpayer Advocate's interest in ensuring consumers are fully informed of their choices. The IRS believes the best approach to combat potential problems is to give taxpayers all the information they need to make decisions with regard to their refunds. For this reason, the IRS conducts extensive communications before and during the filing season to ensure taxpayers are aware of the alternatives — including the low-cost electronic options the IRS itself makes available through its partners.

The National Taxpayer Advocate makes six recommendations in the report.

The IRS will explore the possibility of establishing a Compliance indicator that can be passed to "Where's My Refund," which if implemented would result in a message telling impacted taxpayers their refund is being delayed due to Compliance issues. While the IRS continually improves the features of this application, the cost and complexity of providing more specific information for all circumstances that may impact the amount and/or timing of a refund must be examined.

The IRS agrees that taxpayers should be well informed about their refund options and the expected time it takes the IRS to issue a refund. The IRS's education and outreach program is extensive. Refund issuance and promoting the "Where's My Refund" web and phone look-up tools are key messages built into filing season and new media communications

each year starting with the filing season kick off and continuing throughout filing season including tax tips, news releases, YouTube videos, widgets, external and internal articles, satellite media tours, etc. In preparation for the 2012 filing season a cross functional team developed and will implement updated, consistent internal and external refund messaging across communication channels and vehicles — especially the “Where’s My Refund” landing page, IRS.gov, the *IRS2Go* phone app, the IRS Refund Cycle Chart, and filing season media products. We will work with IRS relationship managers and our partners in the tax and banking industries to promote a consistent refund message and, when necessary, explain delays to taxpayers.

The IRS agrees that providing taxpayers the ability to receive a refund electronically in lieu of a paper check is advantageous for both the government and the taxpayer. In 2015, when we renegotiate the software contract for VITA/TCE electronic preparation and transmission of taxpayer returns, we will consider adding debit card options.

The National Taxpayer Advocate recommends the IRS pursue the ability to assign a portion of refunds to preparer bank accounts. As noted in the National Taxpayer Advocate’s own draft report, the Anti-Assignment Act prohibits the IRS from issuing a check or payment to an account not owned by the taxpayer. In addition, according to regulations contained in Circular 230 and a subsequent Counsel memorandum, there is a clear prohibition on the negotiation of a taxpayer’s check (or electronic refunds) received with respect to a tax liability. Further, our experience with the current split refund program indicates this would increase the risk of fraud that could not be easily controlled by the IRS and would place additional burden on the agency to oversee, regulate, investigate, and review millions of additional transactions.

Due to the low participation rate, Treasury made a decision to terminate the 2011 Treasury-sponsored debit card pilot for tax refunds and will not offer the cards during the 2012 filing season. If Treasury considers sponsoring a debit card for tax refunds in future tax years, the IRS would work with it to explore the feasibility and options.

Finally, the IRS will consider the recommendation relating to Circular 230, but we question whether amending Circular 230 would be effective policy and whether such change is necessary at this time. Circular 230’s section on fees contains language prohibiting “unconscionable fees.” To the extent that consumer protections in the refund products area are needed, the IRS already has due diligence requirements that compel preparers to disclose costs to their clients. In order to impose discipline using Circular 230, IRS has to show by clear and convincing evidence that a practitioner voluntarily and intentionally violated a known legal duty. Any expectations regarding how refund delivery options are disclosed and explained may be more in the realm of the new Federal Consumer Protection agency.

## Taxpayer Advocate Service Comments

We commend the IRS for its continued commitment to educate taxpayers, both before and during the filing season, about refund options. As the IRS rolls out CADE 2 in 2012, it is more important than ever to educate taxpayers about the quick turnaround times associated with government-sponsored options. By providing clear and complete information, including both the range and average refund times associated with these refund choices, the IRS can help taxpayers make informed decisions. We also encourage the IRS to pursue the enhancement of “Where’s My Refund” to include compliance information. In fact, the IRS should consider examining this issue as part of its Real Time Tax System Initiative, which officially began during a public meeting on December 8, 2011.

The National Taxpayer Advocate believes the incorporation of Western Union’s MoneyWise prepaid card in the TaxWise software provides an unfair advantage to the Western Union product and is essentially an indirect endorsement of the product by the IRS. In its response, the IRS states that the debit card feature was not incorporated into the software at the time the IRS entered into the contract with CCH. If the product was added to the software without IRS approval, the IRS should have the authority under the existing contract to demand that it is eliminated immediately. Conversely, if the product was added with IRS approval, it is an improper endorsement. Thus, the IRS should review the terms of the current contract to pursue the immediate elimination of all references by TaxWise to the debit card product in software packages and marketing materials distributed to volunteer sites. It is highly inappropriate to allow the existing arrangement to continue for three more years to the detriment of taxpayers. Once the product is removed, it can be offered externally along with other debit card products. Further, when the IRS renegotiates the contract with CCH for VITA/TCE electronic preparation and transmission of returns, we urge the IRS to address debit cards as well as other commercial refund products. The IRS has the authority to review the terms of all commercial products offered on the software, and the vendor should be required to seek IRS approval before marketing any such product on software for volunteer organizations. Moreover, the IRS should make it clear to the VITA/TCE partners and their customers that it does not endorse any commercial refund products incorporated into existing vendor software.

In its response, the IRS lists several obstacles to the development of a program allowing taxpayers to pay preparation fees through split refund arrangements. The National Taxpayer understands the need for legislative action before the IRS can undertake this initiative. We also believe the IRS must comprehensively evaluate the safeguards necessary to prevent fraud. However, if the IRS successfully proposes legislative changes and can minimize the risk of fraud, it would provide a valuable service by enabling taxpayers to pay preparation fees without incurring the high costs associated with some commercial products.

We are disappointed that Treasury discontinued the debit card pilot after just one filing season. We realize that participation was lower than expected, perhaps because direct mailing did not work well with this population. However, the IRS and Treasury may be able to reach these taxpayers through other means, such as registration at a post office.<sup>40</sup> We encourage the IRS and Treasury to review the findings of the program to determine how to increase participation in a future pilot. The IRS's response displays remarkable passivity in the face of taxpayer need; we encourage the IRS to evaluate the data from the pilot and develop a more successful product and marketing strategy.

Finally, we believe Circular 230 is the appropriate body of law to include standards of behavior and practice expected of tax return preparers. We are aware of the cost disclosure requirements for electronic return originators (EROs) in Revenue Procedure 2007-40 and IRS Publication 1345, *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns*.<sup>41</sup> However, these ERO requirements do not necessarily cover the same preparers covered by Circular 230, and the sanctions are different. In addition, we disagree with the IRS when it suggests that the Federal Consumer Protection agency may be better suited to oversee how preparers disclose and explain refund delivery options. The IRS already regulates the practices of preparers pursuant to the provisions of Circular 230. There is no reason to delegate part of this responsibility to another agency.

## Recommendations

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

1. Enhance "Where's My Refund" to include more detail about delays due to compliance initiatives.
2. Undertake an aggressive public awareness campaign to educate taxpayers about the reduced return processing time as well as its impact on refund turnaround times for government-sponsored refund options. This campaign should also inform taxpayers about the questions they should ask before purchasing a commercial refund product, such as a debit card.
3. Immediately require that CCH remove all references to the Western Union debit card product from the standard TaxWise software the IRS requires VITA/TCE sites to use, or negotiate terms for debit card services as part of its contracting for VITA/TCE tax preparation software.
4. Evaluate the possibility of providing taxpayers with the ability to assign a portion of refunds to preparer bank accounts as long as the IRS modifies Form 8888 to require

<sup>40</sup> In Australia, individuals can obtain a Load&Go card at the post office. This product is a reloadable Visa prepaid debit card. For more information, see <http://auspost.com.au/personal/what-is-loadandgo-card.html> (last visited Dec. 15, 2011).

<sup>41</sup> Rev. Proc. 2007-40, 2007-26 I.R.B. 1488 (June 25, 2007).

the preparer to enter the PTIN and adds a checkbox indicating the taxpayer's awareness of the refund splitting arrangement.

5. Partner with Treasury and the financial sector to offer a Treasury-sponsored debit card for tax refunds, and use the results of the Treasury debit card pilot to design a more desirable product and a more effective marketing strategy.
6. Take a more proactive role in oversight of commercial refund delivery products, including amending Circular 230 to require preparers to inform taxpayers about the costs and accurate timeframes associated with each refund delivery option, with associated sanctions for failure to do so, and developing an information sheet for use by preparers.

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

### RESPONSIBLE OFFICIAL

Richard E. Byrd Jr., Commissioner, Wage and Investment Division

### DEFINITION OF PROBLEM

When a taxpayer's paper refund check is stolen, the IRS asks the Treasury's Financial Management Service (FMS) to issue a replacement check. 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. In recent years, refund theft has evolved from stealing refund checks from the mail to directing the deposits of tax refunds to thieves' bank accounts. To do so, a thief may alter a tax return intercepted from the mail or an unscrupulous return preparer may alter the direct deposit account number on a return.

The IRS has detailed procedures for replacing stolen paper refund checks, but it has limited procedures for replacing stolen electronic refunds. The taxpayer's ultimate recourse is to pursue legal action against the thief, with no help from the IRS. This lack of procedures causes disparate treatment of taxpayers who elect to receive their refunds electronically compared to those who choose to receive paper checks. Even as the IRS promotes electronic filing and payments, the risk of stolen direct deposits creates a disincentive for taxpayers to e-file.<sup>1</sup>

### ANALYSIS OF PROBLEM

#### Background

*The IRS has procedures for processing a claim for a lost or stolen paper refund check.*

The IRS has established procedures to address theft of a paper refund. The taxpayer completes a Form 3911, *Taxpayer Statement Regarding Refund*, and the IRS contacts FMS. In turn, FMS verifies that no person negotiated the check, cancels it, and returns the credit to the IRS, which sends a new refund record to FMS, which then issues a new check to the taxpayer.<sup>2</sup> If FMS identifies that the paper check has been negotiated, it sends a copy of the check (front and back) to the taxpayer, along with an FMS Form 1133, *Claim Against the United States for the Proceeds of a Government Check*. The form asks a series of questions about the negotiation of the check, which the taxpayer must answer. The taxpayer must

<sup>1</sup> See Internal Revenue Manual (IRM) 21.4.2 (Aug. 26, 2011) (discussing Form 3911). By March 1, 2013, the government will pay all non-tax government payments and benefit payments electronically, either by direct deposit or with a pre-paid debit card. See Department of the Treasury website <http://www.godirect.org>.

<sup>2</sup> The negotiation of a check is the process of conversion into cash or the equivalent value. <http://www.merriam-webster.com/dictionary/negotiate>.

also sign the form three times, and FMS compares these signatures with the check endorsement to determine if the check is forged.

FMS's Check Claims Branch (CCB) decides whether a Form 1133 is valid. If the CCB determines (from examination of the evidence, an opinion from the Questioned Documents Branch, a Secret Service investigation, or a bank protest) that a payee was not involved in the negotiation of the check,<sup>3</sup> FMS issues a settlement check to the payee and charges the Check Forgery Insurance Fund (CFIF).<sup>4</sup> The CFIF is a revolving fund established by statute to settle claims of non-receipt where a third party fraudulently negotiated the original check and to make sure that innocent payees receive timely settlement checks.<sup>5</sup>

***The IRS has limited procedures for correcting direct deposit errors.***

The IRS has limited procedures to correct an IRS error that results in depositing a refund into the wrong bank account.<sup>6</sup> The IRS asks the bank to return the funds, but if the bank does not cooperate, the IRS issues a refund to the taxpayer.<sup>7</sup>

In situations where the taxpayer or return preparer made an error that results in a misdirected direct deposit (DD) refund, the IRS asks the bank to return the funds, but the IRS does not pay reimbursement.<sup>8</sup> The IRS may make the same request if it believes a party intentionally misdirected a refund for purposes of theft, even though the IRS does not have the authority to *require* the return of funds that the bank deposited into the account indicated in the Automated Clearinghouse (ACH) record.<sup>9</sup>

TAS has previously discussed in depth the problems taxpayers encounter when the IRS electronically deposits a refund into a third-party bank account.<sup>10</sup> Insufficient procedures for stolen or misdirected DD refunds can leave taxpayers worse off than if they had requested paper checks. This contradicts the improvements in technology that make it easier for both the taxpayer and the government to issue a DD tax refund.

***The IRS has limited procedures for a claim for a lost or stolen direct deposit.***

If a taxpayer inquires about a missing DD, the IRS refers the claim to FMS, which processes refund trace records following guidelines in the Green Book, *A Guide to Federal Government*

<sup>3</sup> The payee is one to whom money is or is to be paid. <http://www.merriam-webster.com/dictionary/payee?show=0&t=1311771315>.

<sup>4</sup> A settlement check is a replacement check based on the Form 1133 claim issued by FMS to replace the original check. Internal Revenue Manual (IRM) 21.4.2.4.13 (Dec. 20, 2010).

<sup>5</sup> See 31 U.S.C. § 3343.

<sup>6</sup> IRM 21.4.5.10.1 (May 2, 2011).

<sup>7</sup> IRM 21.4.5.10.1(3)a (May 2, 2011). IRS reimbursement under this provision is distinct from FMS reimbursement out of the CFIF.

<sup>8</sup> A misdirected refund is a result of a return with the wrong account number. "The IRS is not responsible for misdirected direct deposits that are a result of bank error or the taxpayer providing the wrong Routing Transit Number (RTN) or bank account number." IRM 21.4.5.10(2) (Jan. 7, 2011).

<sup>9</sup> IRM 21.4.1.4.7.5(4) (Oct. 1, 2011). The Automated Clearing House (ACH) transfers refunds or funds electronically for participating depository financial institutions. IRM 3.17.79.1.1 (Jan. 1, 2011).

<sup>10</sup> See National Taxpayer Advocate 2005 Annual Report to Congress 315-325 (Most Serious Problem: *Direct Deposit of Income Tax Refunds*).

*ACH Payments and Collections.*<sup>11</sup> FMS asks the receiving financial institution to verify receipt of the funds and provide information on their disposition, but does not request any personally identifiable information about the owner of the bank account where the IRS deposited the funds.<sup>12</sup> The institution completes a form verifying deposit of the funds in the given account, supplying copies to the payee account owner and FMS, which in turn forwards a copy to the IRS.<sup>13</sup>

FMS guidelines state in part, “If the taxpayer or the taxpayer’s agent gave incorrect account information, neither FMS nor IRS will assist the taxpayer with recovering the funds, and the taxpayer is free to pursue civil actions.”<sup>14</sup> The IRS interprets this guideline as relief from further obligation as long as the account is the one listed on the return.<sup>15</sup> However, an unauthorized third party who wrongfully inserts an inaccurate bank account number on a return is not “the taxpayer’s agent,” so payment to the listed account would not relieve the IRS of the obligation to pay the taxpayer.<sup>16</sup> The IRS’s narrow and incorrect interpretation of FMS guidelines leaves taxpayers with little recourse to recover their stolen DD tax refunds.

With no revolving fund like the CFIF to settle claims for stolen or misdirected DD refunds, FMS may not reimburse payees for these refunds. As discussed above, the CFIF was created by a statute (before the computer age) that specifically refers to a “check,” with long-standing rules and regulations that do not contemplate electronic payments.<sup>17</sup>

***The IRS continues to promote direct deposit as a means to receive a quicker tax refund check, yet has insufficient procedures to resolve instances where a direct deposit refund is stolen.***

Despite the IRS’s insufficient procedures for handling stolen electronic tax refunds, the IRS continues to promote DD as the faster, more efficient way to receive a refund.<sup>18</sup> However, the IRS and tax preparers fail to inform taxpayers that there is no easy way to replace a stolen or misdirected DD refund. Because the IRS is unwilling to help victims of tax refund theft, some taxpayers have contacted TAS for assistance in recovering DD refunds they did not receive.

<sup>11</sup> FMS defines the *Green Book* as a comprehensive guide for financial institutions that receive ACH payments from and send payments (*i.e.*, collections) to the federal government. The ACH is a fund transfer system governed by the National Automated Clearing House Association, a non-governmental organization, which provides for the interbank clearing of electronic entries for participating financial institutions. *Green Book*, Glossary 9-1, available at <http://www.fms.treas.gov/greenbook/intro/index.html> (last visited Aug. 15, 2011).

<sup>12</sup> *Green Book, Federal Government Participation in the Automated Clearing House* 3-8.

<sup>13</sup> IRM 21.4.2-2 (Nov. 2, 2011); IRM 21.4.2-5 (Oct. 20, 2009).

<sup>14</sup> *Green Book, Federal Government Participation in the Automated Clearing House* 1-9.

<sup>15</sup> *Cf.* IRM 21.4.1.4.7.5 (Oct. 1, 2011).

<sup>16</sup> TAS consultation with FMS Office of Chief Counsel (Apr. 25, 2011).

<sup>17</sup> Congress established the CFIF by law in 1941, before the advent of electronic checks. Pub. L. No. 77-310, 55 Stat. 777 (Nov. 21, 1941). While unrelated regulations provide for electronic checks, the CFIF regulations and rules contemplate forgery of signatures on paper. *Compare* 31 C.F.R. § 240.3 (relating to electronic Treasury checks) with §§ 235.1 *ff.* (governing CFIF); see also *Treas. Fin. Man.* vol. 1, pt. 4, § 7055.

<sup>18</sup> See, e.g., IRS, *Get your refund faster – Tell IRS to Direct Deposit Your Refund to One, Two or Three Accounts*, revised Dec. 29, 2010, <http://www.irs.gov/individuals/article/0,,id=163764,00.html> (last visited Sept. 12, 2011).

### Existing Rules Allow the IRS to Implement Procedures.

The IRS should establish a process for a taxpayer to show that whoever wrongfully altered the bank account number on a return was not an authorized agent. Upon confirmation of the facts, the IRS should pay the refund to the taxpayer.<sup>19</sup> In case of a stolen DD, the IRS Office of Chief Counsel previously has advised that “the Service is legally permitted to reissue the refund to the taxpayer.”<sup>20</sup>

In the case of a return fraudulently altered by a preparer, the IRS should have even more reason to assist the taxpayer. While an unauthorized third party who alters a return may be a mere thief, an errant preparer is abusing a recognized role in the tax system. Citing recommendations by the National Taxpayer Advocate and others, the IRS has taken a widely-publicized position asserting authority to regulate preparers. Not long ago, an IRS report stated, “that tax return preparers and the associated industry play a pivotal role in our system of tax administration and they must be a part of any strategy to strengthen the integrity of the tax system.”<sup>21</sup> Consequently, regulations recommended by that report “will increase tax compliance and allow taxpayers to be confident that the tax return preparers to whom they turn for assistance are knowledgeable, skilled, and ethical.”<sup>22</sup> If the IRS has regulatory authority over preparer ethics, then it should have authority over preparer fraud.

Accordingly, the proposed process to show alteration of the bank account number by an unauthorized person would encompass an errant preparer. Certain cases have held that a return wrongfully altered by a preparer is not valid.<sup>23</sup> Similarly, the IRS should not treat an account number wrongfully altered by a preparer as valid.

### CONCLUSION

The IRS currently reimburses taxpayers in case of IRS error and has legal authority to do so in case of a stolen DD refund. Moreover, the IRS may be obligated to pay reimbursement if someone other than “the taxpayer’s agent” caused the error. To provide relief to victims of DD refund fraud, the National Taxpayer Advocate offers these preliminary recommendations:

1. Establish procedures that make no distinction between paper and electronic refund theft or loss, setting forth standards of evidence upon which the IRS will reimburse the taxpayer.

<sup>19</sup> As indicated above, it is unclear whether the CFIF could reimburse these payments since the applicable statute refers to “forged endorsement” of paper checks. 31 U.S.C. § 3343.

<sup>20</sup> FSA 2000-38-005 (June 6, 2000) (stating advice confirmed in TAS consultation with IRS Office of Chief Counsel, Sept. 14, 2011); see also 31 C.F.R. § 210.4(a)(1) (indicating that an agency that accepts an ACH authorization shall verify “the validity of the recipient’s signature”).

<sup>21</sup> IRS Pub. 4832, *Return Preparer Review* (Dec. 2009) 32.

<sup>22</sup> 75 Fed. Reg. 14,539 (Mar. 26, 2010).

<sup>23</sup> See IRS Office of Chief Counsel Memo. to Special Counsel (National Taxpayer Advocate), June 27, 2011; Chief Counsel Memo. re: Horse’s Tax Service (May 12, 2003) at <http://www.irs.gov/pub/lanoa/pmta-2011-013.pdf>; see also *Beard v. Comm’r*, 82 T.C. 766 (1984) *aff’d per curiam* 793 F.2d 139 (6th Cir. 1986); Chief Counsel Memo. re: Refunds Improperly Directed to a Preparer (Dec. 17, 2008).

2. Train IRS employees involved in refund processing how to recognize and correct accounts where fraud is an issue.
3. Seek additional amounts if the fund that currently reimburses taxpayers in case of IRS error proves insufficient for the proposed purpose.

### IRS COMMENTS

The IRS is committed to providing relief to victims of direct deposit refund fraud. The IRS recognizes that the process for addressing stolen or misdirected refund claims differs between paper check and direct deposit refunds and we are working to make improvements in this area.

When a taxpayer's refund appears to be stolen or misdirected, the IRS initiates a refund trace through FMS regardless of whether the refund was issued by paper check or direct deposit. The IRS relies on FMS to make a determination on the replacement of IRS paper check refunds. The FMS Check Claims Branch determines whether a stolen or misdirected paper check claim is valid and a replacement check issued. Determinations are based on an examination of the evidence, an opinion from the Questioned Documents Branch, a Secret Service investigation, or a bank protest. Once the CCB makes a determination that a payee was not involved in the negotiation of the check, FMS issues a settlement check without any intervention or additional input from the IRS. The Check Forgery Insurance Fund funds the replacement check.

The procedures for tracing and replacing a direct deposit refund in cases of IRS error are comprehensive. FMS performs the requested trace and notifies IRS of the results. When the IRS determines it made an error and misdirected a direct deposit refund, the impacted taxpayer receives a replacement refund. The IRS requests the bank return the misdirected funds, but regardless of whether sufficient funds are available for the bank to return, the IRS reimburses the taxpayer for the full refund amount. In these cases, since the error occurred due to IRS processing, the liability for replacing the misdirected funds lies with the IRS. In such cases, the erroneous refunds are transferred to the general ledger 1540 account. This account represents erroneous refund receivables rather than an account to be funded.<sup>24</sup>

When the IRS determines a direct deposit refund was stolen or the taxpayer or return preparer made an error that resulted in a misdirected direct deposit, the IRS is only able to issue a replacement when the bank returns the funds. The IRS requests the bank return the funds, but it does not have the authority to direct a bank to return funds that are not available if the bank applied the funds as directed by IRS in the Automated Clearinghouse

<sup>24</sup> IRM 3.17.64.17.2.3(1) (Sept. 1, 2011).

record.<sup>25</sup> The CFIF is not available to fund the replacement of the refunds and there is no similar fund to cover replaced direct deposits.

The IRS is working with FMS to improve the process of tracing direct deposit refunds and recouping misdirected funds from financial institutions. For example, IRS and FMS personnel are collaborating to improve the current paper-based direct deposit refund trace process of mailing FMS Forms 150.1 or 150.2 to banks. In order to achieve parity with the paper check process, however, legislative changes may be needed to allow settlement for direct deposit refunds out of the CFIF or to establish a similar, but separate, fund for reimbursing taxpayers for stolen or misdirected direct deposit refunds.

The IRS agrees that providing employees with the appropriate training is important for the IRS to meet its goal of providing a high degree of accuracy to every taxpayer. To accomplish its goals of providing quality service, each year IRS functions conduct a thorough review of the training provided to employees to make sure they have the tools necessary to respond to taxpayers in an appropriate manner. In the return processing centers, all employees are provided with annual fraud awareness training. This training helps employees to improve the identification of questionable refund returns.

With respect to the recommendation to seek additional amounts for the fund that currently reimburses taxpayers in case of IRS error, please note that currently there is no fund for this purpose. The CFIF is currently available only to fund reimbursements to taxpayers for stolen or misdirected paper check refunds. There is no similar fund for direct deposit refunds. Reimbursements due to IRS error are currently written off. Legislative changes may be needed to establish an account similar to the CFIF to reimburse misdirected or stolen direct deposit refunds.

<sup>25</sup> IRM 21.4.1.4.7.5(4) (Oct. 1, 2011). The ACH transfers refunds or funds electronically for participating depository financial institutions. IRM 3.17.79.1.1 (Jan. 1, 2011).

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS recognizes the disparity in reimbursement of stolen or lost direct deposits and paper checks. As cited in the response, the IRM refers to missing direct deposit cases in which “the taxpayer alleges preparer fraud,” but these IRM provisions lack standards to prove that allegation. On the other hand, paper check forgery is subject to stipulated evidentiary standards as detailed in the response. In addition, the National Taxpayer Advocate is pleased that the IRS agrees with the importance of training employees how to deal with refund fraud.

We agree that neither the CFIF nor any similar fund covers replacement of stolen or lost direct deposits; indeed, that is the reason for the recommendation to identify appropriate funds. As the response acknowledges, the IRS replaces direct deposits when it believes liability lies with the IRS due to processing error. However, it is unclear if the IRS escapes liability merely by delivery to a designated account when that account number has been wrongfully altered.

On August 16, 2011, the National Taxpayer Advocate issued four Taxpayer Assistance Orders to the Deputy Commissioner, Services and Enforcement, to adjust the accounts of taxpayers who were victims of return preparer fraud. The IRS complied with these Taxpayer Assistance Orders and is moving the diverted portions of the refunds from the taxpayers’ accounts to an internal account.

As the response indicates, the IRS has the authority to designate funds to cover its liabilities. While legislation could create a specific fund for the proposed purpose, this existing authority calls into question whether legislation would be necessary. Rather, the IRS should exercise this authority to designate funds for reimbursement of stolen or lost direct deposits and should seek budgetary supplements if needed.

## Recommendations

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

1. Set forth standards of evidence upon which to reimburse a taxpayer who proves elements of direct deposit theft.
2. Draw on IRS funds to reimburse proven victims of direct deposit theft, seeking additional amounts as necessary.

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

### RESPONSIBLE OFFICIAL

David R. Williams, Director, Return Preparer Office

### DEFINITION OF PROBLEM

In 2011, the IRS made tremendous strides in creating and implementing a system to regulate tax return preparers. Most significantly, preparers must now obtain Preparer Tax Identification Numbers (PTINs) before preparing all or substantially all of a tax return for compensation. Through September 2011, over 735,000 preparers acquired PTINs.<sup>1</sup> The IRS is also developing a Form 1040-based examination, a continuing education program, and a compliance strategy.

While the National Taxpayer Advocate commends the IRS for its accomplishments, she has two main concerns as the IRS continues to develop the program:

- **Development of Business Examinations.** In its Return Preparer Review, the IRS committed to develop two types of examinations.<sup>2</sup> The National Taxpayer Advocate understands that the IRS needed to focus initially on the 1040-based exam. However, the IRS should develop two more examinations for business returns as soon as feasible, with the first exam devoted to payroll tax issues and the second covering corporate, partnership, and complex Schedule C topics. 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.<sup>3</sup> 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.
- **Consumer Protection Campaign.** As the IRS continues to educate return preparers about the new requirements, it can also protect taxpayers by conducting a comprehensive public awareness campaign to educate taxpayers about the rules. Most importantly, the message should convey to taxpayers that their preparers need to sign the return, enter a PTIN, and give the taxpayer a copy of the return. This campaign will

<sup>1</sup> Information provided by the Return Preparer Office (Oct. 20, 2011).

<sup>2</sup> The IRS published the Return Preparer Review in January 2010. It included the results of a six-month study of the return preparer industry as well as several recommendations which formed the basis for the current IRS initiative to register, test, and require continuing education requirements for preparers. IRS Publication 4832, *Return Preparer Review* (Dec. 2009); IRS, IR-2010-1, *IRS Proposes New Registration, Testing and Continuing Education Requirements for Tax Return Preparers Not Already Subject to Oversight* (Jan. 4, 2010).

<sup>3</sup> The gross federal tax gap attributable to employment tax is estimated at \$54 billion. The portion attributable to underreported corporation income is \$30 billion and underreported business income for individual income tax is \$109 billion. IRS, *Update on Reducing the Federal Tax Gap and Improving Voluntary Compliance 4* (July 8, 2009), available at [http://www.irs.gov/pub/newsroom/tax\\_gap\\_report\\_final\\_version.pdf](http://www.irs.gov/pub/newsroom/tax_gap_report_final_version.pdf) (last visited Nov. 4, 2011).

arm taxpayers with the knowledge they need to avoid falling victim to negligent or unscrupulous preparers.<sup>4</sup>

## ANALYSIS OF PROBLEM

### Background

The National Taxpayer Advocate has advocated for the regulation of return preparers since 2002. Specifically, she proposed a program to register, test, and certify return preparers as well as to increase penalties and improve due diligence requirements. Moreover, she recommended that the IRS mount a comprehensive advertising campaign to educate taxpayers about paid preparer requirements to sign and provide a copy of the return to the taxpayer, and how to choose a competent preparer.<sup>5</sup>

In January 2010, the IRS published a report on its study of federal return preparers and related issues, which in most important aspects reflected the proposals made by the National Taxpayer Advocate.<sup>6</sup> The IRS has since implemented the following requirements:

**PTIN Requirement.** In September 2010, Treasury issued regulations requiring preparers who are compensated for preparing or assisting in the preparation of all or substantially all of any U.S. federal tax return, claim for refund, or other tax form submitted to the IRS (with the exception of certain enumerated tax forms) to obtain a Preparer Tax Identification Number. PTIN registration began in the fall of 2010 and the program has issued over 735,000 PTINs as of September 2011.<sup>7</sup> Approximately 62 percent of these PTIN holders are not attorneys, certified public accountants (CPAs), or enrolled agents.<sup>8</sup> Preparers are required to renew their PTINs every (calendar) year.<sup>9</sup>

**Testing Requirement.** Attorneys, CPAs, enrolled agents, certain supervised preparers, and individuals who do not prepare Form 1040 series returns are not required to take the competency test. All other paid preparers must pass an examination that covers the ethical responsibilities of federal tax return preparers as set forth in Circular 230, as well as the basic preparation of Form 1040 series along with the basic related schedules and forms. The

<sup>4</sup> In fiscal year (FY) 2011, the IRS Criminal Investigation Division initiated 371 investigations on allegedly abusive return preparers and 233 cases were recommended for prosecution. See IRS, Statistical Data – Abusive Return Preparers (Oct. 11, 2011), available at <http://www.irs.gov/compliance/enforcement/article/0,,id=106776,00.html> (last visited Oct. 20, 2011).

<sup>5</sup> See National Taxpayer Advocate 2009 Annual Report to Congress 41-69; National Taxpayer Advocate 2008 Annual Report to Congress 503-512; National Taxpayer Advocate 2006 Annual Report to Congress 197-221; National Taxpayer Advocate 2005 Annual Report to Congress 223-237; National Taxpayer Advocate 2004 Annual Report to Congress 67-88; National Taxpayer Advocate 2003 Annual Report to Congress 270-301; National Taxpayer Advocate 2002 Annual Report to Congress 216-230; *Fraud in Income Tax Return Preparation: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 109th Cong. (2005) (statement of Nina E. Olson, National Taxpayer Advocate).

<sup>6</sup> IRS Publication 4832, *Return Preparer Review* (Dec. 2009).

<sup>7</sup> Information provided by the Return Preparer Office (Oct. 20, 2011).

<sup>8</sup> *Hearing on Return Preparation Program Before the U.S. House Comm. on Ways and Means, Subcommittee on Oversight* 1, 4 (July 28, 2011) (statement of David R. Williams, Director, Return Preparer Office, IRS).

<sup>9</sup> TD 9501 (Sept. 30, 2010); IRS, *Requirements for Tax Return Preparers: Frequently Asked Questions*, available at <http://www.irs.gov/taxpros/article/0,,id=218611,00.html> (last visited Sept. 8, 2011).

IRS expects testing to begin in November 2011. Those who are required to take the test and already have a provisional PTIN will have until December 31, 2013 to pass the test.<sup>10</sup>

**Continuing Education.** Beginning in the 2012 calendar year, all preparers required to take the competency exam must complete 15 hours of continuing education per year, including three hours of federal tax law updates, two hours of ethics, and ten hours of other federal tax law.<sup>11</sup> Preparers subject to this requirement cannot renew their PTINs without meeting the requirement.<sup>12</sup>

**Suitability.** All preparers are subject to tax compliance checks. All of those who are not attorneys, certified public accountants, or enrolled agents must also submit to some form of background checks.<sup>13</sup>

**We Commend the IRS for its Accomplishments in Implementing the Registration System but Believe the IRS Can Better Protect Taxpayers with Two Main Modifications to the Program.**

The National Taxpayer Advocate is pleased with the progress the IRS has made with this important program, which will greatly benefit both taxpayers and tax administration. However, as the IRS further implements the program, the National Taxpayer Advocate has concerns about two issues: (1) the availability of only one competency examination and (2) the lack of a public awareness campaign educating taxpayers about the new preparer requirements.

**The Development of Additional Competency Examinations Covering Business Tax Topics Will Protect Taxpayers and Improve Compliance in the Largest Components of the Tax Gap.**

The IRS committed to develop two examinations for preparers, one covering Form 1040 series returns with wage and nonbusiness income, and the second examination for wage and small business 1040 series returns.<sup>14</sup> However, the IRS decided to first offer only one competency exam covering 1040 series returns, and exempted preparers who do not handle these returns from the requirement.<sup>15</sup> The test specifications released by the IRS in

<sup>10</sup> The IRS has been issuing provisional PTINs to individuals who are not attorneys, CPAs, or enrolled agents to enable them to prepare tax returns prior to meeting competency testing and suitability requirements. Even with the launch of the test in November 2011, the IRS will continue issuing provisional PTINs at least through April 18, 2012 to prevent a disruption in the filing season. Once the IRS stops issuing provisional PTINs, tax return preparers who are required to complete the competency test or suitability requirements must complete these requirements successfully prior to obtaining a PTIN. IRS Notice 2011-80, 2011-43 I.R.B. 591; IRS, IR 2011-96, *IRS Issues Guidance to Further Implement Return Preparer Oversight* (Sept. 21, 2011).

<sup>11</sup> *Hearing on Return Preparation Program Before the U.S. House Comm. on Ways and Means, Subcommittee on Oversight* 6 (July 28, 2011) (statement of David R. Williams, Director, Return Preparer Office, IRS).

<sup>12</sup> Circular 230, 31 C.F.R. Part 10, § 10.6(f)(1)(iii), (rev. Aug. 2011).

<sup>13</sup> Circular 230, 31 C.F.R. Part 10, § 10.5(d), (rev. Aug. 2011); see also <http://www.irs.gov/taxpros/article/0,,id=221009,00.html> (last visited Sept. 12, 2011).

<sup>14</sup> IRS Publication 4832, *Return Preparer Review* (Dec. 2009).

<sup>15</sup> The following preparers are exempt from taking the current minimum competency exam: attorneys, certified public accountants, enrolled agents, enrolled retirement plan agents, enrolled actuaries, "supervised preparers," and individuals who do not prepare Form 1040 series tax returns. IRS, Notice 2011-6, I.R.B. 2011-3 (Jan. 17, 2011).

September 2011 set the topics that may be covered in the competency exam, which include wage, nonbusiness, and business income Form 1040 series returns.<sup>16</sup> The IRS plans to make the exam available in November 2011, but has not publicly committed to develop any other examinations.<sup>17</sup>

The National Taxpayer Advocate understands that the IRS needed to focus initially on one examination. It is reasonable to start with Form 1040 series returns, due to the size and vulnerability of the individual taxpayer population, especially those with low incomes.<sup>18</sup> However, we are concerned that preparers who prepare other returns will continue to do so without passing a minimum competency test. While it is reasonable to expect preparers to know who is subject to the exam, most taxpayers will not know all the details of the requirements and may believe their preparers have demonstrated competency to the IRS if they have IRS-issued PTINs. Thus, it is vital that the IRS develop examinations covering more complex business tax issues.

We recommend that the IRS develop two business examinations. The first exam should be devoted to payroll tax issues due to the significant impact of noncompliance in this area.<sup>19</sup> The payroll service provider industry prepares employment tax returns for over 1.4 million employers.<sup>20</sup> TAS Research found that for tax years 2008 and 2009, payment noncompliance rates for employment tax businesses hovered at or above 20 percent. For those same years, filing noncompliance rates for employment tax businesses were approximately 15 percent.<sup>21</sup> In addition, IRS National Research Program (NRP) 2001 federal tax gap data estimated the employment tax gap at more than \$54 billion.<sup>22</sup> Further, the National Taxpayer Advocate has raised significant concerns over the years regarding the payroll tax industry, payroll service providers (PSPs) in particular.<sup>23</sup> By requiring all individuals who

<sup>16</sup> IRS, IR-2011-89, *IRS Releases Specifications for Registered Tax Return Preparer Test* (Sept. 6, 2011).

<sup>17</sup> *Hearing on Return Preparation Program Before the U.S. House Comm. on Ways and Means, Subcommittee on Oversight* 1, 4 (July 28, 2011) (statement of David R. Williams, Director, Return Preparer Office, IRS).

<sup>18</sup> Approximately 140 million individual taxpayers file Form 1040 returns and approximately 60 percent use preparers. *Hearing on Return Preparation Program Before the U.S. House Comm. on Ways and Means, Subcommittee on Oversight* 5 (July 28) (statement of David R. Williams, Director, Return Preparer Office, IRS).

<sup>19</sup> IRS data shows that 26.8 percent of Forms 940, 941, 943, and 944 returns had a paid preparer in tax year 2009. However, the number is likely substantially higher. IRS, Compliance Data Warehouse (CDW), Business Returns Transaction File (BRTF) for tax year 2009 (Oct. 2011).

<sup>20</sup> Payroll service providers that are members of the National Payroll Reporting Consortium represent over 1.4 million employers with a combined total of more than 35 million employees, over one-third of the private-sector workforce. See <http://www.nprc-inc.org/about.html> (last visited Oct. 20, 2011).

<sup>21</sup> IRS, CDW, BRTF for tax years 2008 and 2009 (Apr. 2011). 2001 tax gap data estimate that noncompliance due to underreported FICA and unemployment taxes amounts to \$14 billion per year. IRS, *Update on Reducing the Federal Tax Gap and Improving Voluntary Compliance* 4 (July 8, 2009), available at [http://www.irs.gov/pub/newsroom/tax\\_gap\\_report\\_final\\_version.pdf](http://www.irs.gov/pub/newsroom/tax_gap_report_final_version.pdf).

<sup>22</sup> IRS, Tax Year 2001 Federal Tax Gap, available at [http://www.irs.gov/pub/irs-news/tax\\_gap\\_figures.pdf](http://www.irs.gov/pub/irs-news/tax_gap_figures.pdf) (last visited Oct. 19, 2011). The tax gap amount for FICA and unemployment taxes amounted to \$14 billion and the self-employment amounted to \$39 billion.

<sup>23</sup> A payroll service provider typically prepares employment tax returns for signature by its common law employer/client and processes the withholding, deposit and payment of the associated employment taxes for its common law employers/clients. When providers go out of business or embezzle their customers' funds, the employers remain liable for the underlying payroll taxes, penalties, and interest, and can experience significant burden. National Taxpayer Advocate 2007 Annual Report to Congress 337-354. Consistent with a 2004 legislative recommendation by the National Taxpayer Advocate, the IRS has issued internal guidance stating that it can assess the Trust Fund Recovery Penalty against third-party payers. See Scott D. Reisher, Director, Collection Policy, *Interim Guidance for Conducting Trust Fund Recovery Penalty Investigations in Cases Involving a Third-Party Payer* (July 1, 2011); National Taxpayer Advocate 2004 Annual Report to Congress 394-399.

prepare all or substantially all of a Form 941, *Employer's Quarterly Federal Tax Return*, or any other employment tax return, and who are not in an exempt category (*i.e.*, attorney, CPA, or enrolled agent) to take a minimum competency exam, the IRS will help professionalize the industry and ensure that such preparers are minimally competent. The American Payroll Association (APA) currently administers examinations to payroll professionals in connection with providing certification credentials. The IRS could partner with the APA to develop a minimum competency exam to meet the needs of the IRS program.<sup>24</sup> Finally, to address the noncompliance found in payroll taxes, we believe the payroll exam should include a vigorous ethics component.

The second business exam should cover complex Schedule C, corporation, and partnership tax issues. 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.<sup>25</sup> IRS data shows that approximately 88.5 percent of business returns were prepared using a paid preparer in tax year 2009.<sup>26</sup> In addition, anecdotal evidence from Local Taxpayer Advocates, the Low Income Taxpayer Clinics, other preparers, and the experience of the National Taxpayer Advocate indicates that return preparer noncompliance is a problem with business tax returns. Thus, requiring preparers of business tax returns to establish minimum competency would help reduce this high level of noncompliance (We anticipate the requirement would apply to the same categories of preparers that are covered by the Form 1040 series examination).<sup>27</sup> At the very least, the IRS should develop studies to validate these concerns.

A commitment by the IRS to develop additional examinations covering business tax topics would send a signal to preparers that the IRS is focused on these returns. Such a commitment might even have an early compliance impact as affected preparers may try to distinguish themselves by showing their competency ahead of time. In the meantime, as the IRS continues to develop policies concerning the Form 1040 series exam, it makes sense to determine the impact of such policies on any future testing requirements.

**A Taxpayer Education Campaign Reminding Taxpayers to Obtain a Copy of Their Returns With Preparer's Signature and PTIN Will Protect Taxpayers Against Fraud, Increase Preparer Compliance, and Help Detect Preparer Noncompliance.**

In the first year of the new program, the IRS focused most communications on making preparers aware of the rules that apply directly to them. We understand why the IRS initially prioritized preparer education over taxpayer communications. During the first year, the

<sup>24</sup> See <http://www.americanpayroll.org/certification/> (last visited Oct. 19, 2011).

<sup>25</sup> IRS, *Tax Year 2011 Federal Tax Gap*, available at [http://www.irs.gov/pub/irs-news/tax\\_gap\\_figures.pdf](http://www.irs.gov/pub/irs-news/tax_gap_figures.pdf) (last visited Oct. 19, 2011).

<sup>26</sup> Specifically, 88.5 percent of Forms 1120, 1120S and 1065 were prepared using a paid preparer for tax year 2009. IRS, CDW, BRTF for tax year 2009 (Oct. 2011).

<sup>27</sup> The Government Accountability Office (GAO) analyzed IRS data from the National Research Program 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. GAO, GAO-10-195, *Tax Gap: Actions Needed to Address Noncompliance with S Corporation Tax Rules* 15 (Dec. 2009).

IRS needed to cast a wide net and persuade as many preparers as possible to register (*i.e.*, bringing preparers into the system before telling taxpayers how to find them). However, since the National Taxpayer Advocate first proposed a system to regulate preparers in 2003, we have taken the position that a taxpayer education campaign is a key component of the program's success.<sup>28</sup> Thus as the program progresses, the IRS needs to devote more resources to informing taxpayers about the rules. Specifically, the message should remind taxpayers that if they paid for tax preparation, their preparer is required to enter the PTIN, sign the return, and provide a copy to the taxpayer.

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. While the IRS cannot guarantee the competency of any registered preparers, especially before they are subject to suitability checks and competency examinations, taxpayers should be able to form their own opinions about a preparer who refuses or neglects to follow the applicable professional rules. Taxpayers may even be able to help police the preparer community if the IRS develops procedures to report noncompliance. Without taxpayer education, the IRS is missing a valuable opportunity to use taxpayers as a compliance mechanism and is unnecessarily putting taxpayers at risk. For example, when the GAO conducted undercover visits to return preparers in 2006, it found that approximately 32 percent of the preparers either did not sign the return or failed to provide an identifying number.<sup>29</sup> If taxpayers are warned to check for these items, they may avoid some of the downstream compliance consequences typically associated with returns prepared by noncompliant or underground preparers. Moreover, if taxpayers know to demand that the preparer put his or her PTIN on the return, the number of "underground" preparers will be minimal.

A taxpayer education campaign could also reduce the number of taxpayers falling victim to fraudulent preparer practices. TAS has received a significant number of cases where a portion of the taxpayer's refund is improperly direct deposited into the preparer's bank account.<sup>30</sup> In many instances, after the taxpayer has left the office, the preparer will change the return to increase the refund and deposit the additional amount into his or her own account. The taxpayer may not realize what happened until the IRS freezes the refund or sends the taxpayer a notice seeking to collect the improper refund. We believe the IRS should warn taxpayers about this significant risk,<sup>31</sup> and stress the importance of obtaining a copy of the return, which would substantiate the taxpayer's case as well as any fraud allegations against the preparer.

<sup>28</sup> See National Taxpayer Advocate 2003 Annual Report to Congress 270-301.

<sup>29</sup> GAO, GAO-06-563T, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors* 23 (Apr. 4, 2006). In addition, out of the 19 returns prepared, all 19 contained errors and the tax liability was wrong on 17 of the 19 returns.

<sup>30</sup> Through fiscal year 2011, TAS had approximately 140 alleged preparer fraud cases open. Each of these cases may be one of many instances of alleged fraud by the preparer and are often part of a concurrent criminal or civil IRS investigation of a potentially broader scheme. TAS, 2011 Refund Fraud CTA Case Referrals (on file with the Taxpayer Advocate Service).

<sup>31</sup> Instructions to IRS Form 8888, *Allocation of Refund (Including Savings Bond Purchases)*.

The IRS should launch this public awareness campaign in the 2012 filing season. The IRS generally has many low-cost communication platforms, but it should use paid advertising if necessary to reach a widespread and diverse audience.<sup>32</sup>

We also believe a publicly-accessible database of PTIN holders is an important tool for taxpayers so they can make informed decisions when choosing a preparer. The IRS has indicated that it plans to build this type of database in several years.<sup>33</sup> We support this decision and encourage the IRS to indicate the type of preparer and any limitations on the types of returns he or she is qualified to handle.

**We Encourage the IRS to Develop a Return Preparer Compliance Strategy That Takes a Responsive Regulation Approach.**

We encourage the IRS to take a “responsive regulation” approach, tailored to address different types of noncompliance, in the preparer compliance strategy now under development.<sup>34</sup> That is, the IRS should start with “soft” compliance touches, such as notices and well-targeted education visits, and progressively step up enforcement actions when a preparer’s actions become more egregious. Accordingly, the Taxpayer Advocate Service will closely monitor the development, implementation, and evaluation of this strategy.

## CONCLUSION

The National Taxpayer Advocate is pleased with the progress made by the IRS in developing a program to regulate return preparers. This program enables the IRS to effectively track preparers, ensure they are competent to prepare tax returns, and coordinate all preparer-related initiatives to effectively provide services and apply enforcement when necessary. We continue to have concerns regarding the limited availability of competency examinations and the delay in the launch of a taxpayer consumer protection and education campaign.

While the IRS continues to develop the return preparer program, the National Taxpayer Advocate preliminarily recommends that it take the following actions:

1. Develop two examinations on business topics, with the first 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.

<sup>32</sup> The IRS should also revise the “Tips for Choosing a Tax Preparer” message that the IRS releases at the beginning of each filing season to prominently display these requirements. Currently, the information is included at the end of the message. See <http://www.irs.gov/individuals/article/0,,id=133088,00.html> (last visited Oct. 19, 2011); IRS, Tax Tip 2011-06, *Points to Keep in Mind When Choosing a Tax Preparer* (Jan. 10, 2011).

<sup>33</sup> *Hearing on Return Preparation Program Before the U.S. House Comm. on Ways and Means, Subcommittee on Oversight* 5 (July 28, 2011) (statement of David R. Williams, Director, Return Preparer Office, IRS).

<sup>34</sup> National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, 74-116 (Leslie Book, *The Need to Increase Preparer Responsibility, Visibility and Competence*); National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 44-74 (Leslie Book, *Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws*).

2. 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.
3. 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.

### IRS COMMENTS

The IRS appreciates that the National Taxpayer Advocate has recognized the significant strides the IRS has made establishing an oversight program for return preparers. We have successfully implemented core program components including PTIN registration, competency testing, and registration of continuing education providers. We continue to work on remaining aspects of the program including establishing suitability requirements, creating and implementing standardized business processes, and finalizing the roles and responsibilities of the newly-created Return Preparer Office (RPO) and its relationship to the Office of Professional Responsibility.

Perhaps most important is our ongoing effort to establish and improve compliance activities that support the ultimate program goal of improving tax administration. The RPO has recently assumed leadership for return preparer compliance activities and is focused on exploring the best methods of identifying problematic preparers and applying the most cost-effective treatments. Building this compliance strategy is an ongoing process but we have already launched a number of trial efforts to help determine what approaches will have the most impact. We look forward to working with the National Taxpayer Advocate and the many organizations representing tax practitioners as our compliance work evolves.

The IRS launched the competency test for individuals seeking to become Registered Tax Return Preparers in November 2011. We anticipate that as many as 400,000 people will take the test by the end of 2013. The test is designed to ensure preparers demonstrate competency with regard to preparation of individual income tax returns. The test is focused on 1040 preparation because these returns account for the largest portion of the tax gap and because the Return Preparer Review concluded this area offers the largest opportunity to improve overall tax administration. The test was developed with the participation of numerous internal and external tax experts in conjunction with an internationally known testing company.

Our goal is to build a data-driven strategy to improve compliance and tax administration more broadly. By requiring all tax preparers to obtain and maintain a single identification number, we now have the ability to analyze preparer-related data in unprecedented detail. We intend to use that data to determine where there are preparer performance issues and identify strategies for improving that performance. In this context, we intend to consider the areas the National Taxpayer Advocate recommends for additional testing, but at this

time, our current efforts are focused on creating and launching the 1040 test. We will also engage with the tax professional community as we determine and implement our strategies to improve preparer compliance.

The Return Preparer Office has crafted a communications strategy that parallels the phased-in nature of the entire return preparer program. During 2010 and 2011, RPO focused its communications on educating return preparers about the new regulations. It is imperative that all preparers understand their responsibilities before preparing returns for compensation. In addition, RPO recognizes the importance of a robust public awareness campaign and we will communicate to consumers about the requirement that tax returns be signed by paid preparers and the mandatory use of a PTIN.

One concern of both the IRS and reputable return preparers is that unscrupulous preparers will continue to prepare returns, but not sign them, in an effort to avoid the regulatory process. If preparers are intentionally noncompliant with the oversight regulations, then there is a likelihood they are also willing to engage in other noncompliant behaviors to benefit themselves or their clients, such as preparing incorrect tax returns. This risk underscores the need to educate consumers about the regulations and to stress the importance of protecting themselves by hiring only preparers who have registered for a PTIN and sign returns.

We share the National Taxpayer Advocate's concern regarding a preparer's misappropriation of a portion of the taxpayer's refund without the taxpayer's consent. We believe it is important to warn taxpayers of this significant risk, in addition to educating them about the new regulations. Therefore, we will make both of these topics part of our future messages to the public.

Within the next few years, the IRS plans to create a publicly-accessible database of PTIN holders. Some time after December 2013, when provisional PTIN holders must have passed the competency test and suitability checks, and after the public database of PTIN holders is available, RPO will launch an extensive marketing campaign to inform taxpayers not only about the signing of returns, but also to use only registered tax return preparers, CPAs, attorneys or enrolled agents for the preparation of individual income tax returns. Our strategy will involve multiple communication tools, including news releases, website updates, YouTube videos, podcasts, and modification to the Form 1040 instructions, to advise taxpayers to use only those return preparers with these credentials who sign returns and use PTINs.

In summary, we appreciate the National Taxpayer Advocate's commendation of the progress with the return preparer program, and we will continue our efforts to make it a successful, effective program.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate supports the continuing commitment of the Return Preparer Office to develop a successful and effective oversight program. We look forward to working with the RPO as the office evolves. We are particularly interested in contributing to the development of the data-driven compliance strategy as well as future public awareness campaigns directed at taxpayers.

In addition, we reiterate the need for the IRS to develop additional exams in areas associated with high levels of noncompliance. The National Research Program data show a high level of underreporting in employment taxes, business income reported on individual returns, and corporate income tax.<sup>35</sup> We urge the IRS to analyze the preparer-related data as soon as it becomes available in order to focus on the areas of high noncompliance specific to preparers. As it develops strategies to address preparer performance in these areas, we encourage the IRS to consider developing a competency examination focusing on these topics. We believe a competency examination for problem areas specific to preparers would protect taxpayers and enable the IRS to redirect its resources to more egregious preparer behavior.

## Recommendations

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

1. 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.
2. 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.
3. 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.

<sup>35</sup> *Update on Reducing the Federal Tax Gap and Improving Voluntary Compliance 4* (July 8, 2009), available at [http://www.irs.gov/pub/newsroom/tax\\_gap\\_report\\_final\\_version.pdf](http://www.irs.gov/pub/newsroom/tax_gap_report_final_version.pdf) (last visited Nov. 4, 2011).

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

### RESPONSIBLE OFFICIAL

Joseph H. Grant, Acting Commissioner, Tax Exempt and Government Entities Division

### DEFINITION OF PROBLEM

In 2010, as many as 730,000 exempt organizations (EOs) had annual gross receipts that were normally \$25,000 or less.<sup>1</sup> Prior to 2006, these small EOs did not have annual IRS reporting requirements, and some had never been required to seek initial recognition of their tax-exempt status.<sup>2</sup> Congress passed section 1223 of the Pension Protection Act of 2006 (PPA) to correct the resulting information gaps.<sup>3</sup> The PPA not only imposes an annual filing requirement on small EOs but also provides that the exempt status of any EO failing to file for three consecutive years is automatically revoked. The statute does not specify how EOs are to apply for reinstatement of exempt status following automatic revocation.

In accordance with the PPA, on June 8, 2011, the IRS notified approximately 275,000 EOs, most of which were public charities, that their tax-exempt status had been automatically revoked. On the same day, the IRS issued guidance on how to apply for reinstatement and provided transitional relief for small EOs.<sup>4</sup> The National Taxpayer Advocate commends the IRS for providing meaningful transitional relief to these organizations. However, the IRS makes it unnecessarily burdensome for EOs to obtain reinstatement following automatic revocation by:

- Not allowing administrative challenges to the accuracy of the automatic revocation;
- Requiring EOs to apply for reinstatement by submitting Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, the same form taxpayers file to request *initial recognition* of exempt status, without plans to use the information on the form in a way that justifies the burden on taxpayers;<sup>5</sup>

<sup>1</sup> IRS response to TAS information request (Aug. 17, 2010). The exact number is uncertain because the available data may not reflect current levels of gross receipts for all organizations. The term "exempt organization" encompasses organizations exempt from federal income tax pursuant to Internal Revenue Code (IRC) § 501(a). "Public charity" refers to a type of organization exempt pursuant to IRC § 501(c)(3), and "includes most organizations active in the arts, education, health care, and human services. They are what most people mean when they use the term 'nonprofit organization.'" (More precisely, public charities and private foundations together comprise "charities," generally speaking, a subset of "exempt organizations," in turn a subset of "nonprofit organizations.") Of all exempt organizations registered with the IRS as of 2005, almost 63 percent were public charities. See Amy Blackwood, Kennard T. Wing & Thomas H. Pollak, *The Nonprofit Sector in Brief, Facts and Figures from the Nonprofit Almanac 2008: Public Charities, Giving, and Volunteering*, Urban Institute, available at [http://www.urban.org/UploadedPDF/411664\\_facts\\_and\\_figures.pdf](http://www.urban.org/UploadedPDF/411664_facts_and_figures.pdf).

<sup>2</sup> See IRC § 508(c)(1)(B), with respect to organizations otherwise exempt under IRC § 501(c)(3). Other organizations specified in IRC § 501 are also not required to seek formal recognition of exempt status.

<sup>3</sup> Pension Protection Act of 2006, Pub. L. No. 109-280 § 1223, 120 Stat. 780, 1090 (2006). See S. Rep. No. 109-336 (2006) 41, accompanying S. 1321, the Telephone Excise Tax Repeal and Taxpayer Protection and Assistance Act of 2006, Tit. III, W. Notification Requirement for Exempt Entities Not Currently Required to File an Annual Information Return.

<sup>4</sup> See IRS Identifies Organizations that Have Lost Tax Exempt Status; Announces Special Steps to Help Revoked Organizations (June 8, 2011), available at <http://www.irs.gov/newsroom/article/0,,id=240239,00.html?portlet=7>.

<sup>5</sup> Organizations seeking recognition of exempt status other than under IRC § 501(c)(3) submit Form 1024, *Application for Recognition of Exemption Under Section 501(a)*.

- Not allocating additional resources to handle applications for reinstatement or taking into account the effect on resources of applications for reinstatement; and
- Not notifying EOs when they have failed to file two consecutive required returns, and automatic revocation is imminent.

## ANALYSIS OF PROBLEM

### Background

Under IRC § 501(a) and (c)(3), EOs devoted to charitable, religious, educational, or certain other purposes may be exempt from federal tax, and contributions to these organizations may be tax deductible.<sup>6</sup> These organizations, most of which are public charities, generally must formally apply for recognition of their tax-exempt status and file annual information returns.<sup>7</sup> From 1969 until 2006, Congress excused these EOs with gross receipts of normally not more than \$5,000 from both applying for recognition and filing returns.<sup>8</sup> Over the same period, the IRS increased the threshold for the annual reporting exception to \$25,000.<sup>9</sup>

As a result, an organization that had to apply for initial recognition under IRC § 501(c)(3) (because its gross receipts exceeded \$5,000) was not necessarily required to file annual returns (because the receipts did not exceed \$25,000) and could thus become “invisible” to the IRS. An organization with gross receipts of less than \$5,000 could dispense with the application for initial recognition of exempt status under IRC § 501(c)(3) and remain invisible as long as its gross receipts stayed below the applicable thresholds.<sup>10</sup>

Because of these exceptions to annual reporting requirements, the IRS could not maintain a reliable record of small EOs' continuing existence. The public could not easily obtain basic information about a nonreporting organization, such as its current address, and the IRS did not know when to omit EOs from its published list of organizations to which charitable contributions could be made.<sup>11</sup> To address these concerns, the PPA imposed an annual reporting requirement on the smaller EOs not previously required to file returns, and further

<sup>6</sup> IRC § 170(c).

<sup>7</sup> IRC § 508(a); IRC § 6033 (a)(1). The general obligation to file annual returns applies to all EOs exempt under IRC § 501(a), not only those described in IRC § 501(c)(3).

<sup>8</sup> IRC § 508(c)(1)(B); Treas. Reg. § 1.508-1(a)(3) (excepting such small EOs that are not private foundations from the obligation to apply for recognition of exempt status); IRC § 6033(a)(3)(A)(ii) (excepting such small EOs from filing an annual information return).

<sup>9</sup> IRC § 6033(a)(3)(B) provides discretionary exceptions from filing information returns where such filing is not necessary to the efficient administration of the internal revenue laws. In Rev. Proc. 80-44, 1980-2 C.B. 777, the IRS exempted organizations that are not private foundations and normally have annual gross receipts of not more than \$10,000 from the annual filing requirement; in Rev. Proc. 83-23, 1983-1 C.B. 687, the IRS increased the gross receipts amount to \$25,000. With Rev. Proc. 2011-15, 2011-3 I.R.B. 322, the IRS increased the gross receipts amount to \$50,000, applicable for tax years beginning on or after Jan. 1, 2010.

<sup>10</sup> See, e.g., Treas. Reg. § 1.508-1(a)(3)(ii), defining gross receipts as not normally more than \$5,000 depending on how long the organization has been in existence. Moreover, Form 1024 lists 14 other types of organizations specified in IRC § 501(c) (e.g., civic leagues, business leagues, and social clubs) most of which are not required to obtain formal recognition to be tax-exempt but may obtain formal recognition by submitting Form 1024.

<sup>11</sup> See S. Rep. No. 109-336 (2006) 41, accompanying S. 1321, the Telephone Excise Tax Repeal and Taxpayer Protection and Assistance Act of 2006, Tit. III, W. Notification Requirement for Exempt Entities Not Currently Required to File an Annual Information Return.

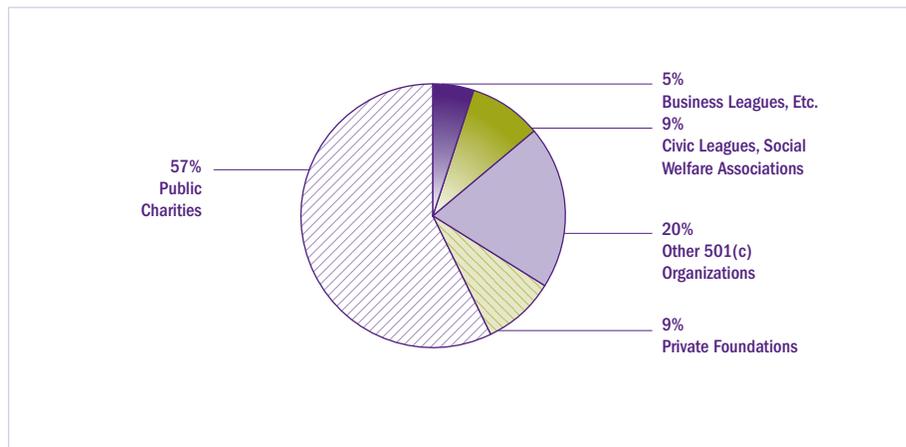
provided for automatic revocation of exempt status of any EO failing to report as required for three consecutive years.<sup>12</sup>

The PPA did not remove the exception for applying for initial recognition of tax-exempt status under IRC § 501(c)(3); EOs with gross receipts that are normally \$5,000 or less are still not required to apply. However, the PPA requires an EO seeking *reinstatement* of exempt status following automatic revocation to submit an application, even if the EO was not required to apply for initial recognition.<sup>13</sup> The statute does not specify how the EO should make the reinstatement application.

### Revoked Organizations Were Primarily Small Public Charities

Information is available for about half of the organizations listed as revoked in June 2011.<sup>14</sup> Of these 144,980 organizations, most were public charities that had last reported revenue of less than \$25,000, as shown in Figures 1.24.1 and 1.24.2, below.

**FIGURE 1.24.1, Revoked Organizations by Type<sup>15</sup>**



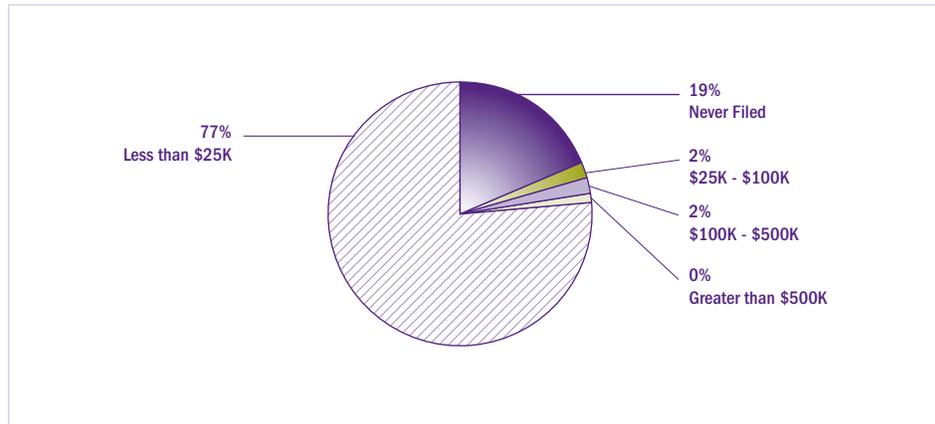
<sup>12</sup> Section 6033(i) now requires small EOs not otherwise required to file an annual return to submit Form 990-N, *Electronic Notice (e-Postcard) for Tax-Exempt EOs Not Required to File Form 990 or 990-EZ*. The obligation to file annual returns applies to all EOs exempt under IRC § 501(a), not only those described in IRC § 501(c)(3). Exceptions to the new reporting requirement include churches, their integrated auxiliaries, and conventions or associations of churches. IRC § 6033(j) provides for automatic revocation for failing to file required returns for three consecutive years.

<sup>13</sup> IRC § 6033(j)(2) ("Any EO the tax-exempt status of which is revoked under paragraph (1) must apply in order to obtain reinstatement of such status regardless of whether such EO was originally required to make such an application.")

<sup>14</sup> According to GuideStar (the registered trademark and operating name of GuideStar USA, Inc., a § 501(c)(3) nonprofit organization that provides information about nonprofits), of the 279,595 nonprofits on the June list of revoked organizations, 134,615 "either never appeared on the IRS list of exempt organizations or have not been on it for some time." See Chuck McLean and Suzanne E. Coffman, *For Whom the Revocations Told: An In-Depth Analysis* (June 2011), GuideStar, available at <http://www2.guidestar.org/xa/news/articles/2011/for-whom-revocations-tolled.aspx>.

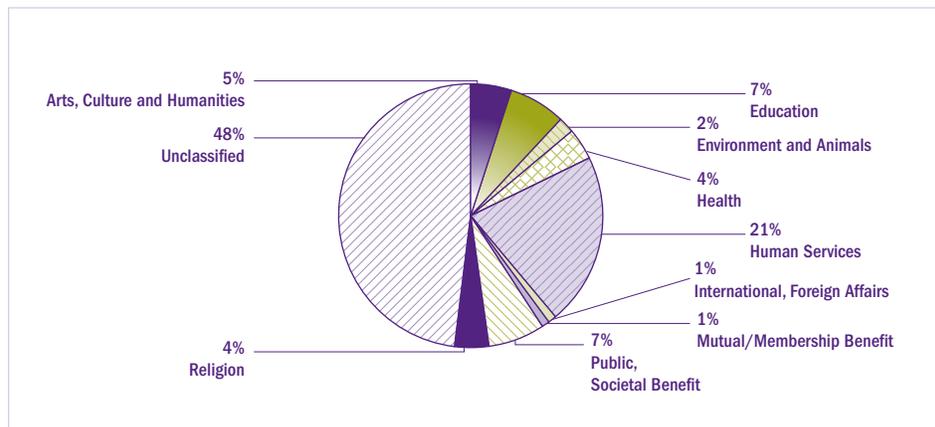
<sup>15</sup> Chuck McLean and Suzanne E. Coffman, *For Whom the Revocations Told: An In-Depth Analysis* (June 2011), GuideStar, available at <http://www2.guidestar.org/xa/news/articles/2011/for-whom-revocations-tolled.aspx>.

**FIGURE 1.24.2, Revoked Organizations by Last Reported Revenue<sup>16</sup>**



The largest activity sector identified for the revoked organizations was human services, as shown in Figure 1.24.3.

**FIGURE 1.24.3, Revoked Organizations by Sector<sup>17</sup>**



<sup>16</sup> Chuck McLean and Suzanne E. Coffman, *For Whom the Revocations Told: An In-Depth Analysis* (June 2011), GuideStar, available at <http://www2.guidestar.org/txa/news/articles/2011/for-whom-revocations-told.aspx>.

<sup>17</sup> *Id.* The "Human Services" designation, based on the National Taxonomy of Entities (NTEE) system used by the IRS, encompasses "Crime & Legal-Related, Employment, Food, Agriculture & Nutrition, Housing & Shelter, Public Safety, Disaster Preparedness & Relief, Recreation & Sports, Youth Development and Human Services." See Urban Institute, National Institute for Charitable Statistics, *National Taxonomy of Exempt Entities* (2009), available at <http://nccs.urban.org/classification/NTEE.cfm>. It is not clear whether the IRS will continue to use the NTEE classification system. See IRS Announcement 2011-36 (June 27, 2011), Issues for Public Comment, Activity Codes, available at [http://www.irs.gov/irb/2011-26\\_IRB/ar12.html](http://www.irs.gov/irb/2011-26_IRB/ar12.html).

### Judicial Review of Automatic Revocations Is Not Available, Yet the IRS Does Not Provide an Avenue for Administrative Review.

When an EO's exempt status is revoked, the EO becomes subject to tax on its receipts, and if the organization was exempt under IRC § 501(c)(3), its donors can no longer deduct their contributions, both of which are serious consequences that may prevent the organization from continuing operations. Administrative review rights would normally exist to allow EOs to contest revocation,<sup>18</sup> and the PPA does not preclude administrative appeal. However, the IRS declines to provide administrative appeals of its conclusion that an EO's exempt status was *automatically revoked*, instead advising taxpayers to simply contact the IRS in the event of a dispute.<sup>19</sup> The absence of this basic taxpayer protection is compounded by the fact that judicial review of automatic revocations is not available.<sup>20</sup> The National Taxpayer Advocate recommends that Congress require the IRS to provide for administrative review of automatic revocations.<sup>21</sup>

### Requiring a Full Form 1023 for Reinstatement Burdens Taxpayers and Is Not Justified by the Manner in Which the IRS Intends to Use the Information the Form Provides.

The PPA does not prescribe any particular IRS form to apply for reinstatement as an IRC § 501(c)(3) organization, but the IRS requires a full Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, thereby equating a request for *reinstatement* of exempt status with a request for initial *recognition* of that status. The IRS could have developed – but did not – a less burdensome method of applying for reinstatement other than a full Form 1023, which the IRS estimates takes about two working days to complete.<sup>22</sup> Cyber Assistant, a web-based software program that the IRS is developing to assist in the preparation of Form 1023, is not yet available.<sup>23</sup> The IRS asserts, “We also are seeking other ways to use this information to better focus our outreach and

<sup>18</sup> Rev. Proc. 2011-9, 2011-2 I.R.B. 283, secs. 12 and 7 (Jan. 10, 2011).

<sup>19</sup> For example, the answer to Frequently Asked Question 10, “If an organization on the Auto-Revocation List has documentation that it met its filing requirement for one or more years during the three-year period, what should it do?” is: “An organization possessing documentation (an IRS receipt for a filed return, for example) that shows it has *not* failed to file for three consecutive years should contact Customer Account Services, or send the documentation directly to the Exempt Organizations Account Unit.” The answer to Frequently Asked Question 11, “If an organization on the Auto-Revocation List has a letter from the IRS stating that it does not have an annual filing requirement, what should it do?” is: “An organization with a letter from the IRS stating that it does not have an annual filing requirement should contact Customer Account Services.” See Automatic Exemption Revocation for Non-Filing: Frequently Asked Questions, available at <http://www.irs.gov/charities/article/0,,id=221600,00.html>.

<sup>20</sup> IRC § 7428(b)(4).

<sup>21</sup> See Legislative Recommendation: *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, infra.*

<sup>22</sup> IRS Instructions for Form 1023 at 24. The instructions also indicate that taxpayers should expect to spend over two weeks of recordkeeping for the form. In addition, applicants must complete appropriate schedules and submit various attachments.

<sup>23</sup> Release of Cyber Assistant has been delayed until further notice. Internal Revenue Manual (IRM) 3.45.1.10.6.2 (Mar. 29, 2011), available at <http://serp.enterprise.irs.gov/databases/irm.dr/current/3.dr/3.45.dr/3.45.1.dr/3.45.1.10.6.2.htm>. The IRS's Tax Exempt and Government Entities division (TE/GE) cannot predict when Cyber Assistant will become available. IRS response to TAS information request (Aug. 26, 2011). The National Taxpayer Advocate this year recommends that Congress fund and order the IRS to implement Cyber Assistant. See Legislative Recommendation: *Provide Administrative Review of Automatic Revocations of Exempt Status, Develop a Form 1023-EZ, and Reduce Costs to Taxpayers and to the IRS by Implementing “Cyber Assistant,” infra.*

education to small organizations.” However, it remains unclear why information elicited by a Form 1023-EZ would not serve the same purpose equally well.

### **The IRS Does Not Take Increased Volume of Applications Into Account in Planning or in Allocating Resources.**

The large volume of automatic revocations could be expected to trigger an increase in the number of requests for reinstatement the IRS receives, yet the IRS has not increased the staffing for processing exemption applications.<sup>24</sup> TE/GE does not appear to know how long it takes, on average, to make a determination in response to a Form 1023,<sup>25</sup> but it can be a lengthy process, and a significant increase in volume may make it even lengthier.<sup>26</sup> Moreover, because TE/GE does not and has no plans to track the number of calls to the IRS call site that taxpayers are directed to contact regarding automatic revocation, the unit is not positioned to know how much additional staff it will need to handle future requests for reinstatement.<sup>27</sup> TE/GE simply does not take these requests into consideration in its planning.<sup>28</sup>

### **The IRS Provided Transitional Relief for Small EOs.**

The PPA provides that reinstatement, if granted, is effective as of the date of the application. However, if the EO can show reasonable cause for its failure to file, reinstatement may be retroactive to the date of revocation.<sup>29</sup> In June 2011, the IRS provided guidance on how it will administer this aspect of the statute. Generally, to obtain retroactive reinstatement, an organization must explain and substantiate its reasonable cause for failing to file an information return for *each* of the three years that culminated in the automatic revocation.<sup>30</sup> However, the IRS will treat some organizations as having reasonable cause

<sup>24</sup> TE/GE, *Exempt Organizations Annual Report and Fiscal Year 2011 Work Plan* 3, 6 (charting volume of annual determinations of applications for tax exemption and volume of EO on-roll employees over a three-year period, showing 364 Rulings and Agreements employees in FY 2008 and 366 in FYs 2009 and 2010), available at [http://www.irs.gov/pub/irs-tege/fy2011\\_eo\\_workplan.pdf](http://www.irs.gov/pub/irs-tege/fy2011_eo_workplan.pdf). As of Oct. 7, 2011 (*i.e.*, four months after the IRS notified organizations of the revocations), about 5,500 organizations had requested reinstatement following automatic revocation. IRS response to TAS information request (Oct. 12, 2011).

<sup>25</sup> In response to TAS's request for information about processing times, broken down by requests that can be disposed of at a screening stage and those that require further development, TE/GE referred to its Business Performance Review (Aug. 16, 2011) which shows processing time for initial applications on Form 1023 aggregated with processing times for Form 1024 and for other determinations, such as public charity and private foundation status determinations, advance approval of scholarship grant procedures, and group determinations of tax-exempt status. The figures are not broken down between requests that can be developed through screening versus those requiring full development. IRS response to TAS information request (Aug. 26, 2011).

<sup>26</sup> For applications that do not require development, the IRS either issues a determination letter or requests additional information within approximately 90 days. As of Aug. 29, 2011, the IRS was assigning to an agent applications needing development that were received in March 2011. *Where Is My Exemption Application?*, available at <http://www.irs.gov/charities/article/0,,id=156733,00.html>. However, as a letter to Commissioner Shulman from Rep. Cao indicates, although the IRS's website in 2009 indicated that processing an application for recognition of tax-exempt status would take six to eight weeks, the process, according to Rep. Cao, took six to eight months. Letter from Rep. Cao to Commissioner Shulman (June 17, 2009) (on file with TAS). For a discussion of the delays experienced in obtaining an Exempt EO ruling, see, e.g., National Taxpayer Advocate 2007 Annual Report to Congress 210-221.

<sup>27</sup> IRS response to TAS information request (Aug. 17, 2010).

<sup>28</sup> See Tax Exempt and Government Entities Business Performance Review 15 (Aug. 16, 2011) (stating that “EO expects a potential increase of applications from organizations that were revoked for the non-filing of returns. These potential applications are not factored into our overall projections.”), available at [http://tege.web.irs.gov/content/PLANMainWindow/LinkedHtmlDocuments/TEGE\\_3rd\\_Qtr\\_BPR\\_FY2011.pdf](http://tege.web.irs.gov/content/PLANMainWindow/LinkedHtmlDocuments/TEGE_3rd_Qtr_BPR_FY2011.pdf).

<sup>29</sup> IRC § 6033(j)(2), (3).

<sup>30</sup> IRS Notice 2011-44, 2011-25 I.R.B. 883 (June 9, 2011). Additional requirements, including a 15-month deadline from the time of revocation, apply.

for the failure to file returns sufficient to obtain reinstatement retroactive to the date of automatic revocation, simply by submitting their application by December 31, 2012. These are organizations that had annual gross receipts of not more than \$50,000 in the most recently completed tax year; were not required to file a Form 990 prior to 2007; and were eligible to file an e-Postcard in 2007, 2008, and 2009.<sup>31</sup> In addition, organizations eligible for this transitional relief may submit their application for a reduced user fee of \$100.<sup>32</sup> The National Taxpayer Advocate commends the IRS for recognizing the unique challenges small EOs face and providing this transitional relief.

TE/GE recently concluded a pilot research study on the communication preferences and educational needs of small EOs.<sup>33</sup> Phase 2 of the study, a telephone survey completed in June 2011, showed that the IRS website and tax professionals are the primary sources of information for small and midsize organizations. The program with the highest awareness, usage, and perceived value to compliance is the IRS website.<sup>34</sup> Accordingly, the IRS delivered information about the transitional relief through the website. It also reached out to practitioner groups, umbrella organizations, and state officials, asking them to share information about revocation, reinstatement, and transitional relief for small organizations.<sup>35</sup>

The National Taxpayer Advocate designated automatic revocations as meeting the TAS Public Policy criterion that qualifies taxpayers for TAS assistance.<sup>36</sup> TAS developed guidance about automatic revocations, including transitional relief, for employees who handle calls on this issue,<sup>37</sup> and Local Taxpayer Advocates included a discussion of transitional relief in their outreach to congressional offices.

### **In the Future, the IRS Needs to Better Communicate with Small EOs Before Exempt Status Is Automatically Revoked.**

In 2009, the IRS began notifying EOs required to submit an e-Postcard that they had not done so, but did not issue a second reminder to file for the same tax year.<sup>38</sup> The IRS is

<sup>31</sup> Notice 2011-43, 2011-25 I.R.B. 882 (June 9, 2011).

<sup>32</sup> Rev. Proc. 2011-36, 2011-25 I.R.B. 915 (June 9, 2011). The user fee for filing Form 1023 is usually \$400 for EOs with gross receipts of \$10,000 or less and \$850 for those with gross receipts in excess of \$10,000. Rev. Proc. 2011-8, 2011-1 I.R.B. 237 (Jan. 3, 2011). Taxpayers who prepare a Form 1023 using Cyber Assistant will pay a lower user fee.

<sup>33</sup> IRS response to National Taxpayer Advocate 2009 Annual Report to Congress, Most Serious Problem: *Targeted Research and Increased Collaboration Are Needed to Meet the Needs of Tax Exempt Organizations* (recorded on the Joint Audit Management Enterprise System (JAMES) database Jan. 2011). The pilot study is named EO Services and Assistance (EOSA).

<sup>34</sup> IRS response to TAS information request (Aug. 26, 2011); Tax Exempt and Government Entities Business Performance Review 15 (Aug. 16, 2011), available at [http://tege.web.irs.gov/content/PLANMainWindow/LinkedHtmlDocuments/TEGE\\_3rd\\_Qtr\\_BPR\\_FY2011.pdf](http://tege.web.irs.gov/content/PLANMainWindow/LinkedHtmlDocuments/TEGE_3rd_Qtr_BPR_FY2011.pdf).

<sup>35</sup> IRS response to TAS information request (Aug. 26, 2011).

<sup>36</sup> IRM 13.1.7.2.4 (Apr. 26, 2011) provides: "Criteria 9 - The NTA determines compelling public policy warrants assistance to an individual or group of taxpayers. The NTA has the sole authority for determining which issues are included in this criteria and will so designate by memo. Example: The NTA decided any inquiries related to organizations where the IRS automatically revoked their tax-exempt status because the organization did not file an annual return or notice for three consecutive years."

<sup>37</sup> The guidance includes a question and answer document and flowchart, as well as a series of links to the latest information available from the IRS.

<sup>38</sup> In contrast, Form 990 and 990-EZ filers routinely receive two reminders to file for the same tax year. See IRM 21.3.8.10.2.7 (Oct. 1, 2010). Even though e-Postcard filers cannot obtain an extension to file and cannot file for a prior year without using an e-file service provider, a second reminder might avert a second failure to file.

aware that many small EOs are staffed by volunteers who typically do not remain with the organization from one year to the next and may not know of the previous (or subsequent) year's failure to file.<sup>39</sup> Nevertheless, the IRS did not notify EOs that more than one failure to file had already occurred, and automatic revocation was therefore imminent. Especially now that the IRS is gathering better information about EOs, such as their current addresses, these types of reminders may help avert automatic revocations in the future.

## CONCLUSION

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

1. The IRS should allow administrative review of its conclusion that an organization's exempt status was automatically revoked.
2. The IRS should develop a Form 1023-EZ for use by small organizations.
3. The IRS should expedite the development of Cyber Assistant for Form 1023 preparation.
4. The IRS should notify EOs when they have failed to file two consecutive returns or e-Postcards, and automatic revocation is imminent.

## IRS COMMENTS

The IRS is proud of its implementation of Congress' mandate in § 1223 of the Pension Protection Act of 2006, which automatically revokes the exemption of any organization that has failed to file required returns or notices for three consecutive years. The IRS took unprecedented steps in bringing awareness of the provision to the exempt organizations community through targeted as well as general outreach. The IRS also provided small organizations additional time for filing after releasing a preliminary list of organizations for which we had not received a filing. Slightly larger organizations were also given an opportunity to come into compliance without losing their tax-exempt status. In addition, after the revocation list was released, the IRS provided a special transition process for smaller organizations to have their tax-exempt status reinstated. In the years building up the imposition of the automatic revocation, and in this period following revocation, the IRS has continually taken steps to assist EOs, especially those that are smaller.

The IRS disagrees that we have made it unnecessarily burdensome for EOs to obtain reinstatement following automatic revocation. The PPA provides that an organization, revoked by operation of law, must apply in order to obtain reinstatement of such status regardless of whether such organization was originally required to make such an application. In accordance with the statute, automatically revoked organizations must file an application for exemption just like any other organization seeking an IRS determination of tax-exempt status.

<sup>39</sup> Notice 2011-43, 2011-25 I.R.B. 882 (June 9, 2011).

To simplify matters for an organization seeking reinstatement, the IRS provides a wealth of information on automatic revocation and reinstatement through the Charities and Non-profits page of the IRS website. In addition, when an organization is added to the Automatic Revocation List, the IRS sends a letter to the organization's last known address to inform the organization that its tax-exempt status has been revoked. This letter refers the organizations to our web page for further information about revocation, reinstatement and transitional relief. Because we recognize that we may not have valid addresses for some of the revoked organizations, we have also reached out to practitioner groups, umbrella groups and state officials and asked them to share information about revocation, reinstatement and transitional relief for small organizations.

As the report of the National Taxpayer Advocate explains, organizations seeking recognition as public charities—which gives them the dual tax advantages of exemption from income tax and eligibility to receive tax-deductible contributions—must submit Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*. The IRS does not believe that a less comprehensive application satisfies Congress' intent in requiring automatically revoked organizations to apply to the IRS for recognition of exemption. The legislative history of the PPA indicates that Congress understood and intended that revocation (and the associated statutorily required application for reinstatement) to be a significant consequence for those organizations that did not file even one of the three required notices in spite of the fact that those organizations held themselves out as tax-exempt.

As explained in the report of the National Taxpayer Advocate, Congress imposed two new requirements on small EOs when it passed the PPA. The PPA imposed an annual filing requirement on small EOs and also provided that the exempt status of any EO failing to file for three consecutive years is automatically revoked. The legislative history describes Congress' intent in adopting the new annual filing requirement as follows:

Accordingly, the Committee believes that exempt organizations that do not have to file an annual information return by virtue of the amount of their gross receipts should file with the Secretary a simple, short annual notice. The committee *does not intend that the annual filing be burdensome* and does not believe that a monetary penalty is appropriate for a failure to file the notice.<sup>40</sup>

While it is apparent, therefore, that Congress did not want small EOs to file the Form 990 or the Form 990-EZ, there is no such language indicating that Congress also wanted to spare automatically revoked organizations from filing the Form 1023 when applying for reinstatement. Moreover, the committee report indicates that Congress saw revocation,

<sup>40</sup> Report to Accompany S. 1321, the Telephone Excise Tax Repeal and Taxpayer Protection and Assistance Act of 2006, Title III, Subtitle W., "Notification Requirement for Exempt Entities Not Currently Required to File an Annual Information Return," S. Rep. No. 109-336, at 41 (2006) (emphasis added). The language to which this report referred was subsequently enacted as part of the Pension Protection Act of 2006. Following Congress' instructions, the IRS developed the Form 990-N.

and the required application for reinstatement, as a suitable penalty for failing to satisfy an intentionally simple notice requirement.

However, if an organization is unable to file a notice with the Secretary for three consecutive years, the Committee believes that revocation of the organization's exempt status *is an appropriate sanction under the circumstances*. In addition, the sanction of loss of exempt status is extended to consecutive failures to file a required information return.<sup>41</sup>

The report of the National Taxpayer Advocate questions why the IRS needs all of the information requested by a Form 1023. The IRS believes that its obligation to decide whether an organization qualifies for exemption, by itself, justifies the extent of information requested on the Form 1023. Automatically revoked organizations are subject to the same requirements for exemption as all other organizations; therefore, the IRS needs the same quality and quantity of information to make an exemption determination.

The Form 1023 also serves an educational purpose because it provides applicants either an introductory or a refresher course on the rules for tax exemption. Finally, the law encourages transparency and accountability to the public by requiring organizations to make their Form 1023 exemption applications and their Form 990-series information returns available to the public.

The report of the National Taxpayer Advocate recommends that the IRS develop a Form 1023-EZ for use by small organizations and expedite the development of Cyber Assistant for Form 1023 preparation. The IRS developed Cyber Assistant, a web-based software program, to help 501(c)(3) applicants file a complete and accurate Form 1023 and improve the quality and consistency of these applications. Software testing revealed problems requiring correction prior to public launch, and the IRS had to delay the release. Because the IRS must balance a number of competing information technology needs, we cannot presently predict when Cyber Assistant will be available. It is important to recognize, however, that Cyber Assistant was designed to accommodate the current Form 1023. Any significant changes in the Form 1023 would more than likely require substantial reprogramming of Cyber Assistant.

The report of the National Taxpayer Advocate has recommended that the IRS should allow "administrative review of its conclusion that an organization's exempt status was automatically revoked." The IRS disagrees as there is not any IRS "conclusion" about automatic revocation to be reviewed; automatic revocation of exemption occurs by operation of law. Revenue Procedure 2011-9 is inapplicable in the case of automatic revocation. It describes administrative review of the conclusion, at the end of an examination, that an organization is no longer organized or operated for exempt purposes. Automatic revocation involves no such conclusion. It occurs, by operation of law, simply because an organization has failed to meet its filing requirements for three consecutive years. There is no IRS conclusion to be administratively reviewed.

<sup>41</sup> S. Rep. No. 109-336, at 41-42 (emphasis added).

The IRS agrees that it is critical that only those organizations that have failed to meet their filing requirements for three consecutive years will be identified by the IRS as having their exemptions automatically revoked. For that reason, many business units of the IRS have worked collaboratively since shortly after the passage of the PPA to ensure that IRS records correctly reflect those organizations that have failed to meet filing requirements for three consecutive years. The IRS relies on automated data processing systems to generate the names of organizations that failed to meet their filing requirements for three consecutive years. The IRS recognizes that in rare cases automated systems can produce mistaken results either because of programming issues or because of faulty data. The IRS has issued public guidance to organizations to notify us about organizations that have been erroneously included on the Automatic Revocation List so the mistake can be corrected. When an organization brings an error to our attention, the organization is removed from the Automatic Revocation List.

The IRS would like to provide some additional perspective on its preparation for the submission of reinstatement applications. The IRS did take the increased volume of applications into account when planning and allocating resources. The IRS engaged in contingency planning on how to use existing staff, based both at EO Determinations in Cincinnati and at the National Office in Washington, D.C., in a variety of functions to meet whatever application processing needs were presented once automatically revoked organizations began to apply for reinstatement.

Based on the number of applications for reinstatement since the first Automatic Revocation List was posted in June 2011, Congress appears to have been correct that the vast majority of automatically revoked organizations are defunct. With the initial list posted in June and with monthly updates since, the number of automatically revoked organizations totaled around 385,000 on October 7, 2011. As of October 14, 2011, the IRS had received about 5,500 reinstatement applications (less than 1.5 percent). The IRS appreciates the importance of processing applications for exemption in a timely manner and we have closed almost half of these to date.

The report of the National Taxpayer Advocate suggests that the IRS needs to better communicate with small EOs at risk of automatic revocation. As support for this proposition, the report notes that the IRS sends only one reminder each year to organizations that fail to file Form 990-N, while it sends two to organizations that fail to file a Form 990 or a Form 990-EZ. The first reminder (Notice CP259E), which is sent to non-filers of Forms 990-N, 990 and 990-EZ, explains that if they fail to file for three consecutive years, they will lose their tax-exempt status. The second notice—the EO Return Delinquency Notice, which is only sent to Form 990 and Form 990-EZ filers—contains information about financial and criminal penalties that do not apply to Form 990-N filers. Accordingly, the IRS does not send it to them. In addition, Form 990 and Form 990-EZ filers are subject to daily penalties that

may accrue up to \$50,000 for each unfiled return,<sup>42</sup> while the Code specifically provides that such penalties do not apply to failures to file Form 990-N.<sup>43</sup> Especially given current budget constraints, the value in sending a second reminder simply repeating the first is unclear.

The IRS agrees that it is important that EOs be informed of their filing requirements and the possibility of automatic revocation. After passage of the PPA, the IRS sent multiple letters to EOs about filing requirements and automatic revocation. As Congress intended by imposing the notice requirement and mandating automatic revocation for those that failed to file for three consecutive years, the IRS now has much more accurate information on addresses of exempt organizations. Failure-to-file notices will be sent to the updated addresses on record and we will continue to monitor whether additional notices are necessary.

### Taxpayer Advocate Service Comments

The National Taxpayer Advocate commends the IRS to the extent that it conducted outreach and allowed transitional relief to small charities. There is no dispute that the Pension Protection Act of 2006 provides for automatic revocation of exempt status. As the IRS points out, Congress viewed *revocation* as an appropriate sanction for failing to report as required for three consecutive years. However, nothing in the legislative history of the PPA indicates that Congress also intended the *reinstatement process* to operate as a sanction for failing to report. Just because Congress provided that “revoked” organizations must apply for reinstatement does not mean that it intended the process to be disproportionately burdensome or punitive. Nor, contrary to the IRS’s assertion, is a full Form 1023 necessary order to make a determination about the exempt status of a small EO. For many if not most small EOs, one or two pages of questions that elicit basic information would suffice. Instead, they are confronted with 12 pages of questions that are likely inapplicable,<sup>44</sup> sometimes mind-numbingly so.<sup>45</sup> Small organizations need a Form 1023-EZ, and Form 1023 filers need Cyber Assistant to help complete it.

The IRS refers to “competing information technology needs” to explain why it cannot predict when Cyber Assistant will become available. The National Taxpayer Advocate notes that the IRS has anticipated processing applications prepared using Cyber Assistant at least

<sup>42</sup> IRC § 6652(c)(1)(A).

<sup>43</sup> IRC § 6652(c)(1)(E).

<sup>44</sup> For example, Part V, question 1b is: “List the names, titles, and mailing addresses of each of your five highest compensated employees who receive or will receive compensation of more than \$50,000 per year.” A Form 1023-EZ could simply ask if any employees received more than \$50,000 per year in compensation from the organization. If the answer is “yes”, then the EO could be required to file the full Form 1023.

<sup>45</sup> For example, Part VIII, question 11 is: “Do you or will you accept contributions of: real property; conservation easements; closely held securities; intellectual property such as patents, trademarks, and copyrights; works of music or art; licenses; royalties; automobiles, boats, planes, or other vehicles; or collectibles of any type? If “Yes,” describe each type of contribution, any conditions imposed by the donor on the contribution, and any agreements with the donor regarding the contribution.”

since 2008.<sup>46</sup> The user fee for applications prepared using Cyber Assistant was to be \$200, independent of the size of the organization.<sup>47</sup> An organization presently required to pay \$850 (already a significant cost for many small EOs) could save \$650 and apply that money to its direct program services if Cyber Assistant were available. The software will not replace the paper application form, which the applicant will still print and mail to the IRS, but it will help applicants avoid errors or leave mandatory sections of the form incomplete. The release of software like Cyber Assistant will reduce cost and burden to taxpayers and to the IRS; these criteria should make it a priority for modernization funding.<sup>48</sup>

Lengthy processing times for Form 1023 continue to burden taxpayers. A check of the IRS website “Where is my exemption application?” on December 10, 2011, indicated that the IRS was assigning to reviewers Form 1023 applications that were received in May 2011.<sup>49</sup> This means that any organization that submits an application that is not “plain vanilla” will have to wait at least seven months to be assigned to a reviewer, and many more months to get the exemption ruling letter. As a matter of routine business, these delays are unacceptable and can impede the delivery of important program services. Moreover, these delays could drive exempt organizations to submit “bare-bones” applications so that they can get in the queue early, and use the intervening time to develop supporting documentation to present to the reviewer. TE/GE needs to staff its EO function appropriately for its workload, and Congress should fund the IRS accordingly.

The IRS’s description of its role in the automatic revocation process is that of a disinterested bystander, exercising no judgment and arriving at no conclusions. This is contrary to the facts. Although the IRS cannot control whether taxpayers file required returns, it is the first arbiter of whether returns are required. As the IRS acknowledges, it is the custodian of the returns. The PPA requires the IRS to publish accurate lists of organizations to whom deductible contributions can be made and organizations whose exempt status was automatically revoked. The IRS’s role in the automatic revocation process is therefore central. It cannot escape responsibility by portraying the process as driven solely by automation or operation of law. The IRS asserts that it responds appropriately when an organization demonstrates that the IRS included it on the Automatic Revocation list in error, and we expect that this is indeed the situation when the decision maker for the IRS agrees with the taxpayer that an error occurred. The National Taxpayer Advocate commends the IRS for correcting revocation errors, the existence of which warrant an organized review process. Our concern is that there is no mechanism for review of disputed cases, and the IRS should provide one.

<sup>46</sup> IRM 3.45.1.4.6.2 (Jan. 1, 2008) describes procedures for processing Forms 1023 prepared with Cyber Assistant.

<sup>47</sup> See IRS Notice 1382 (Rev. Sept. 2009) advising taxpayers that Cyber Assistant would become available in 2010 and the user fee for applications prepared using Cyber Assistant would be \$200. Rev. Proc. 2011-8, 2011-1 I.R.B. 237, sec. 2.06 (Jan. 3, 2011) states, “The references...to application fees after Cyber Assistant availability have been removed because the Service does not expect Cyber Assistant...to become available in 2011.”

<sup>48</sup> See Legislative Recommendation: *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*, *infra*.

<sup>49</sup> See *Where Is My Exemption Application?*, available at <http://www.irs.gov/charities/article/0,,id=156733,00.html>.

As the IRS points out, it is now acquiring more accurate information about exempt organizations. The National Taxpayer Advocate supports the IRS plan to consider whether to provide additional notices, such as a notice explaining that an organization failed to file a required return for two years rather than only one, and that revocation is imminent.

## Recommendations

The National Taxpayer Advocate recommends that the IRS should:

1. Allow administrative review of its conclusion that an organization's exempt status was automatically revoked.
2. Develop a Form 1023-EZ for use by small organizations.
3. Expedite the development of Cyber Assistant for Form 1023 preparation.
4. Notify EOs when they have failed to file two consecutive returns or e-Postcards, and automatic revocation is 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

### RESPONSIBLE OFFICIALS

Richard E. Byrd Jr., Commissioner, Wage & Investment Division  
Chris Wagner, Chief, Appeals

### DEFINITION OF PROBLEM

When married taxpayers file a joint tax return, as more than 98 million people did for 2010,<sup>1</sup> they become jointly and severally liable for the tax shown on the return, as well as for any additional tax, penalties, and interest later determined to be owed.<sup>2</sup> “Joint and several liability” means that each spouse is *individually* responsible for the *entire* tax liability stemming from a joint return, even if all of it is attributable to the other spouse, and the joint filers are no longer married.

Internal Revenue Code (IRC) § 6015, known as the “innocent spouse” provision, provides for relief from this joint and several liability.<sup>3</sup> IRC § 6015(f), sometimes referred to as equitable innocent spouse relief, relieves taxpayers from liability when, taking into account all the facts and circumstances, it would be inequitable to hold an individual liable for the tax.<sup>4</sup> Until recently, a Treasury regulation required taxpayers to request equitable relief within two years after the IRS commenced certain collection activity against the taxpayer seeking innocent spouse relief.<sup>5</sup> The National Taxpayer Advocate has long advocated for removal of the two-year rule that prevented taxpayers from obtaining equitable relief,<sup>6</sup> and is very pleased that on July 25, 2011, the IRS announced the rule was no longer in effect.<sup>7</sup>

<sup>1</sup> For tax year 2010, there were 49,235,798 joint returns. Each joint return is filed by two people. Individual Returns Transaction File Data from the Compliance Data Warehouse tax year 2010 extract cycle 201130 (Aug. 24, 2011).

<sup>2</sup> Internal Revenue Code (IRC) § 6013(d)(3); see Treas. Reg. § 1.6013-4(b).

<sup>3</sup> Taxpayers in community property states who do not file joint returns are generally liable for the tax on half of community income, regardless of which spouse generated the income (*Poe v. Seaborn*, 282 U.S. 101 (1930)); IRC § 66 provides for innocent spouse relief from this type of liability.

<sup>4</sup> IRC § 6015(b) and (c), respectively referred to as “traditional” innocent spouse relief and “separation of liability” relief, provide for relief in other circumstances. To obtain relief under § 6015 (f), relief under (b) or (c) must be unavailable.

<sup>5</sup> Treas. Reg. § 1.6015-5(b). The same two-year rule is a statutory requirement for relief under the other innocent spouse provisions. IRC § 6015(b)(1)(E), (c)(3)(B).

<sup>6</sup> National Taxpayer Advocate 2010 Annual Report to Congress 377 (Legislative Recommendation: *Allow Taxpayers to Request Equitable Relief Under Internal Revenue Code Section 6015 (f) or 66(c) at Any Time Before Expiration of the Period of Limitations on Collection and to Raise Innocent Spouse Relief as a Defense in Collection Actions*); vol. 2, 1-12 (*Unlimit Innocent Spouse Equitable Relief*); National Taxpayer Advocate 2006 Annual Report to Congress 540 (Legislative Recommendation: *Eliminate the Two-Year Limitation Period for Taxpayers Seeking Equitable Relief under IRC § 6015 or 66*).

<sup>7</sup> Notice 2011-70, 2011-32 I.R.B. 135 (July 25, 2011), available at <http://www.irs.gov/pub/irs-drop/n-11-70.pdf>. See *Taxpayer Advocate Commends IRS for Policy Change on Equitable Innocent Spouse Relief*, Tax Notes Today (July 26, 2011), 2011 TNT 143-26.

The IRS removed the two-year rule pursuant to a more general review of procedures in the innocent spouse cases.<sup>8</sup> As of this writing, the review is still in progress. The National Taxpayer Advocate recommends that the IRS:

- Track the number of taxpayers who indicate they are victims of domestic violence or abuse; and
- Require employees to place outbound calls to taxpayers in all innocent spouse cases before making a final determination about whether to grant relief.

## ANALYSIS OF PROBLEM

### Background

Married taxpayers who file a joint return are jointly and severally liable for the tax with respect to the return.<sup>9</sup> Recognizing that this rule sometimes produces unfair results, Congress enacted the first innocent spouse provision in 1971.<sup>10</sup> It revised the rules in 1984 and again as part of the IRS Restructuring and Reform Act of 1998 (RRA 98) to make relief easier to obtain.<sup>11</sup> IRC § 6015 now provides three avenues of relief, under subsections (b),<sup>12</sup> (c),<sup>13</sup> and (f). Subsection (f) is referred to as “equitable” innocent spouse relief because it provides for relief when, “taking into account all of the facts and circumstances, it would be inequitable to hold the individual liable for any unpaid tax or any deficiency.” As opposed to the relief available under IRC § 6015 (b) and (c), IRC § 6015(f) allows relief for underpayments as well as understatements of tax and does not impose any time limit for requesting relief.<sup>14</sup> However, IRS guidance in 2000 and a Treasury regulation in 2002 imposed a two-year deadline parallel to one statutorily prescribed in subsections (b) and (c) on requests for relief under subsection (f).<sup>15</sup>

<sup>8</sup> IR 2011-80, *Two-Year Limit No Longer Applies to Many Innocent Spouse Requests* (July 25, 2011), available at <http://www.irs.gov/newsroom/article/0,,id=242867,00.html>.

<sup>9</sup> IRC § 6013(d)(3).

<sup>10</sup> IRC § 6013(e).

<sup>11</sup> Pub. L. No. 91-679, 84 Stat. 2063 (adding IRC § 6013(e)); Pub. L. No. 98-369 § 424(b)(1), 98 Stat. 494 (expanding the availability of relief under IRC § 6013(e) to encompass any substantial understatement (*i.e.*, over \$500) attributable to a spouse’s grossly erroneous items (including any omission of which the taxpayer did not know or have reason to know.); Pub. L. No. 105-206, § 3201, 112 Stat. 685, 734 (RRA 98) (adding IRC § 6015).

<sup>12</sup> Under IRC § 6015(b), taxpayers may obtain relief only from an understatement of tax – the amount by which the tax reported on the return is less than the tax actually owed. The understatement must be attributable to the other spouse; the spouse requesting relief must demonstrate that he or she did not know, and had no reason to know, of the understatement when the return was signed, and that it would be inequitable to hold him or her liable for the tax; and the request for relief must come within two years of the first collection activity.

<sup>13</sup> Under IRC § 6015(c), taxpayers who are divorced, widowed, legally separated, or living apart from the other spouse for the previous 12 months may obtain relief from an understatement if they request relief within two years of the IRS’s first collection activity. Allocation rules are set forth with the objective of allocating the item that gave rise to the deficiency as it would have been allocated if the spouses had filed separate returns. Relief will generally not be available if the IRS shows that the spouse requesting relief had actual knowledge of the understatement at the time the return was signed.

<sup>14</sup> We use the terms “understatement” and “deficiency” interchangeably to refer to the difference between the amount of tax that had to be shown on the return and the amount that was actually shown. “Underpayment” refers to tax shown on the return but not paid.

<sup>15</sup> See Rev. Proc. 2000-15, 2000-1 C.B. 447, *superseded by* Rev. Proc. 2003-61, 2003-2 C.B. 296; Treas. Reg. § 1.6015-5(b)(1), 67 Fed. Reg. 47,278 (July 18, 2002).

**The IRS Recently Dropped the Two-Year Rule for Requesting Equitable Relief.**

The validity of the two-year rule for equitable innocent spouse claims was questioned in 2009, when the Tax Court, in *Lantz v. Commissioner*,<sup>16</sup> held the regulation imposing the rule invalid. The IRS appealed the Tax Court's decision, as well as other cases with the same issue, and three Courts of Appeal ultimately held that the regulation was valid.<sup>17</sup> Notwithstanding these decisions, in the interest of tax administration, on July 25, 2011, the IRS issued Notice 2011-70, providing that it would no longer require taxpayers to request equitable relief under IRC § 6015(f) within two years of the first collection activity.<sup>18</sup> Pending formal modification of the Treasury regulation, the Notice provides the following transitional rules for IRC § 6015(f) claims.

**Future Requests:** Taxpayers who request relief after July 25, 2011, must do so within the period of limitation on collection or, for any credit or refund of tax, within the statutory period for requesting a refund.<sup>19</sup>

**Pending Requests:** The IRS will now consider requests that were under consideration or in suspense as of July 25, 2011, even if taxpayers submitted them more than two years after the first collection activity, as long as the taxpayers requested relief within the applicable period of limitation on collection or, if applicable, during the statutory period for obtaining a credit or refund.<sup>20</sup> Pursuant to this provision, the IRS sent more than 4,500 letters to taxpayers advising them that it would now consider their claims.<sup>21</sup>

**Requests that were denied solely as untimely and were not litigated:**<sup>22</sup> Taxpayers whose requests were denied as untimely and were not litigated may *reapply* for relief, and the IRS sent nearly 3,000 letters to taxpayers advising them of this opportunity.<sup>23</sup> The IRS will treat the original request for relief as a claim for refund for purposes of the period of

<sup>16</sup> 132 T.C. 131 (2009).

<sup>17</sup> *Lantz v. Comm'r*, 607 F.3d 479 (7th Cir. 2010) *rev'g and remanding* 132 T.C. 131 (2009); *Mannella v. Comm'r*, 631 F.3d 115 (3d Cir. 2011) *rev'g and remanding* 132 T.C. 196 (2009); *Jones v. Comm'r*, 642 F.3d 459 (4th Cir. 2011), *rev'g and remanding* T.C. Docket No. 17359-08 (May 28, 2010).

<sup>18</sup> Notice 2011-70, 2011-32 I.R.B. 135 (July 25, 2011), available at <http://www.irs.gov/pub/irs-drop/n-11-70.pdf>.

<sup>19</sup> The statutory period of limitation on collection is generally ten years after the date the IRS assesses the tax. IRC § 6502(a). Generally, taxpayers must request a refund within three years from the date their return was filed or two years from the time the tax was paid, whichever occurs later, or, if no return was filed, within two years from the time the tax was paid. IRC § 6511(a). A taxpayer who meets the three-year timeframe can recover payments made during the three-year period that precedes the date of the refund claim, plus the period of any extension of time for filing the return. A taxpayer who does not meet the three-year requirement can recover only payments made during the two-year period preceding the date of the refund claim. IRC § 6511(b)(2).

<sup>20</sup> The IRS revised its procedures to allow taxpayers requesting equitable relief from the IRS under IRC § 6015(f) more than two years after collection activity commenced to suspend their request for relief while the validity of the two-year deadline for IRC § 6015(f) claims was being litigated.

<sup>21</sup> As of July 30, 2011, the IRS had sent 4,559 letters to taxpayers (IRS Letter 4754 or Letter 4771) who had requested suspension of their claims pending the outcome of litigation in the courts, or whose claims were pending in IRS Appeals when Notice 2011-70 was issued, advising them that the IRS would consider their claims. IRS response to TAS information request (Sept. 29, 2011).

<sup>22</sup> As the National Taxpayer noted, "I am pleased the IRS will be providing relief from the two-year rule not merely to taxpayers who file future claims but also to most taxpayers whose claims were rejected in the past." See *Taxpayer Advocate Commends IRS for Policy Change on Equitable Innocent Spouse Relief*, Tax Notes Today (July 26, 2011), 2011 TNT 143-26.

<sup>23</sup> As of July 30, 2011, the IRS had sent 2,963 Letters 4767C explaining that taxpayers could reapply for relief. The IRS contacted these taxpayers directly because their cases were still in IRS inventory; the IRS had not closed them because the time for administrative appeal or for filing a Tax Court petition had not expired. IRS response to TAS information request (Sept. 29, 2011).

limitation on refunds. This means any amount for which a refund was available as of the date the original request was filed, and any amount subsequently collected, may be eligible for refund if warranted by the IRS's reconsideration of the claim for equitable relief. With respect to unpaid liabilities, the taxpayer must reapply within the period of limitation on collection. Before the IRS adopted the procedure of giving taxpayers the option of suspending their claims, it denied claims for relief as untimely on average about 1,500 times each year.<sup>24</sup> As of September 24, 2011, the IRS had received 258 reapplications for relief, 79 of which were in response to the IRS's letter advising them that they could reapply.<sup>25</sup>

**Requests in litigation:** On the same day it announced the end of the two-year rule, the government filed motions to dismiss all the appellate cases affected by the change, and the courts have now dismissed all the appeals.<sup>26</sup> For docketed Tax Court cases, including those docketed before the IRS's change in position, the IRS instructed its Chief Counsel attorneys to, among other things, no longer argue that the two-year deadline applies to claims for equitable relief.<sup>27</sup>

**Requests where litigation is now final:** If the IRS stipulated in the court proceeding that relief would have been available if not for the two-year rule, the IRS will take no further collection activity with respect to that portion of the liability (but no refunds or credits will be available). The IRS has identified five cases belonging to this category.<sup>28</sup>

### **In Conjunction with the Change in Policy as to the Two-Year Rule, the IRS Undertook a Review of Equitable Innocent Spouse Procedures.**

IRC § 6015(f) permits taxpayers to request equitable relief pursuant to procedures set by the Secretary, and those procedures are found in Revenue Procedure 2003-61.<sup>29</sup> In June 2011, the IRS assembled a team to review the existing procedures for obtaining equitable relief under IRC § 6015(f) to see if they could be improved.<sup>30</sup> In addition to any new procedures for analyzing innocent spouse cases, there are two procedural matters that the IRS should address.

<sup>24</sup> The numbers of IRC § 6015(f) disallowed untimely claims in FY 2004-10 were 1,127; 377; 1,175; 1,752; 2,053; 2,396; and 1,555, respectively. Email from IRS Wage & Investment Division Compliance function (Dec. 7, 2010) (on file with TAS).

<sup>25</sup> IRS response to TAS information request (Sept. 29, 2011).

<sup>26</sup> *Hall v. Comm'r*, 135 T.C. 374, *appeal dismissed* (6th Cir. Aug. 2, 2011); *Buckner v. Comm'r*, T.C. Docket No. 12153-09, *appeal dismissed* (6th Cir. July 27, 2011); *Payne v. Comm'r*, T.C. Docket No. 10768-09, *appeal dismissed* (9th Cir. July 25, 2011); *Coulter v. Comm'r*, T.C. Docket No. 1003-09, *appeal dismissed* (2d Cir. Aug. 4, 2011). The IRS had already conceded in all these cases that but for the two-year rule, equitable relief would be appropriate.

<sup>27</sup> CC-Notice 2011-017 (July 25, 2011), providing direction for Chief Counsel attorneys handling cases docketed with the Tax Court that involve the two-year deadline.

<sup>28</sup> IRS response to TAS information request (Sept. 29, 2011).

<sup>29</sup> 2003-2 C.B. 296, *superseding* Rev. Proc. 2000-15, 2000-1C.B. 447.

<sup>30</sup> The team consisted of representatives from the Wage & Investment operating division, including analysts in the Cincinnati Centralized Innocent Spouse Unit, Chief Counsel, and TAS.

### Domestic Violence and Abuse<sup>31</sup>

IRS Form 8857, *Request for Innocent Spouse Relief*, solicits information about domestic violence and abuse, and abuse is relevant to determining whether innocent spouse relief is appropriate, but the IRS does not presently track the frequency with which taxpayers indicate they are victims. In a random sample of 290 Forms 8857 submitted in fiscal year 2011, TAS found that 45 taxpayers, or 15.5 percent, indicated they were victims.<sup>32</sup>

### Personal Contact with Taxpayers

The National Taxpayer Advocate has long advocated for more personal IRS contact with taxpayers, in a variety of contexts. For example, over the past seven years, the National Taxpayer Advocate has urged the IRS to adopt collection policies that emphasize personal contact, both by telephone and face-to-face.<sup>33</sup> This year, she reports that an IRS streamlined Centralized Offer in Compromise pilot program that incorporates personal taxpayer contacts has resolved a greater portion of cases in six months or less than the non-streamlined approach, and more often resulted in offer acceptance.<sup>34</sup> As another example, in 2004 the National Taxpayer Advocate reported the findings of a TAS study that explored, among other issues, whether additional contacts and interaction with the taxpayer improved the chances of taxpayers receiving the Earned Income Tax Credit (EITC). The study found that in the context of audit reconsiderations, when TAS employees initiated contact with taxpayers by phone instead of relying solely on correspondence, the likelihood of a taxpayer receiving additional EITC to which he or she was entitled — *i.e.*, of achieving the right result — increased with the number of phone calls made by the TAS employee.<sup>35</sup> Because personal contact may improve timeframes and lead to better decisions, employees who evaluate claims for innocent spouse relief should attempt to contact taxpayers personally before making a final determination.

<sup>31</sup> See Most Serious Problem: *The IRS Does Not Sufficiently Recognize Domestic Violence and Abuse and Its Consequences for Tax Administration*, *supra*.

<sup>32</sup> Just as important as taking abuse into account is the need to better *recognize* that a taxpayer may be a victim and solicit appropriate evidence that might support the claim. The IRS uses training material developed in 2001 to train employees about domestic violence and abuse. The training has been classified as obsolete as of Nov. 2004 and has not been replaced. See IRS Catalog Information, *available at* <http://publish.no.irs.gov/cat12.cgi?request=CAT1&catnum=86924>. The National Taxpayer Advocate this year developed training that is mandatory for all TAS employees and is available to all other IRS employees. *Recognizing and Working with Taxpayers Who Have Experienced Domestic Violence or Abuse*, IRS Enterprise Learning Management System (ELMS) course 41304.

<sup>33</sup> See Most Serious Problem: *The IRS Does Not Emphasize the Importance of Personal Taxpayer Contact as an Effective Tax Collection Tool*, *supra*.

<sup>34</sup> Under the standard program, 48.07 percent of cases are resolved within six months. Under the streamlined program, 68.46 percent of cases are resolved within six months. See Most Serious Problem: *The IRS Does Not Emphasize the Importance of Personal Taxpayer Contact as an Effective Tax Collection Tool*, *supra*. Prior to the streamlined Centralized Offer in Compromise program, the overall acceptance rate was about 25 percent. IRS, Collection Activity Report No-5000-108 (Oct. 2009). After the streamlined process was implemented the acceptance rate rose to 34 percent. IRS, Collection Activity Report No-5000-108 (Oct. 2011).

<sup>35</sup> National Taxpayer Advocate 2004 Annual Report to Congress vol. 2, 1-10 (EITC Audit Reconsideration Study).

## CONCLUSION

The National Taxpayer Advocate commends the IRS for removing the two-year rule for equitable innocent spouse claims, and for its willingness to review its procedures. In conclusion, the National Taxpayer Advocate offers these preliminary recommendations:

1. The IRS should track the number of taxpayers who 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
2. The IRS should revise the IRM to require employees to attempt personal taxpayer contact before making final determinations in all innocent spouse cases.

## IRS COMMENTS

The IRS appreciates the recognition by the National Taxpayer Advocate of the improvements we have made to the Innocent Spouse Program. We believe that the IRS decision to eliminate the two-year rule, as proposed by the National Taxpayer Advocate, will improve administration of the Innocent Spouse Program and provide needed relief to taxpayers.

As noted in the report of the National Taxpayer Advocate, in addition to eliminating the two-year rule, the IRS recently conducted a thorough review of the Innocent Spouse Program. In connection with that review, the IRS is proposing revised rules that apply in innocent spouse determinations. The proposed rules revise the factors that apply for granting equitable relief. The IRS is seeking public comment on these proposed revisions and looks forward to working with the National Taxpayer Advocate and the Low Income Taxpayer Clinics (LITCs), as well as other organizations, in this effort.

Most significantly, the proposed revised rules expand the effect abuse will have in determining whether relief is warranted. As noted in the National Taxpayer Advocate's report, the IRS solicits information about domestic violence and abuse on Form 8857, *Request for Innocent Spouse Relief*, and considers whether that information is relevant to determining whether innocent spouse relief is appropriate. The IRS recognizes that when abuse is present, the requesting spouse may not have been able to challenge the treatment of items on a tax return, question the payment of taxes or challenge the other spouse's assurance regarding the payment of taxes. The new proposed rules recognize that the presence of abuse may mitigate other factors that might otherwise weigh against granting relief. In connection with these changes, the IRS has recently increased its training to innocent spouse unit employees on domestic violence. The IRS takes seriously the effects that domestic violence and abuse may have on taxpayers. We recognize that abusive situations could result in tax consequences to the taxpayer that he or she is sometimes powerless to prevent.

In connection with the changes to the Innocent Spouse Program, the IRS has increased its use of personal taxpayer contact. We are in the process of implementing procedures to

require Innocent Spouse employees to make two attempts at personal contact in all cases where there is insufficient data in the case to make a determination. If an employee is unable to reach a taxpayer after two phone call attempts the employee must issue a letter to the requesting spouse asking for the necessary information.

We will continue to work with the National Taxpayer Advocate and consider recommendations as we finalize improvements to the Innocent Spouse Program.

### Taxpayer Advocate Service Comments

The National Taxpayer Advocate welcomes the IRS's interest and willingness to collaborate with TAS in improving procedures in innocent spouse cases, and we look forward to working together on these issues. We appreciate the IRS's inclusion of LITCs and other stakeholders in the process, and we will work with the IRS to ensure their continued participation. The National Taxpayer Advocate is also pleased the IRS is heightening employee awareness of these issues through training on domestic violence.<sup>36</sup> We note that the IRS does not articulate any objection to tracking the incidence of domestic violence and abuse.

The National Taxpayer Advocate supports the IRS's move toward increased personal taxpayer contact in innocent spouse cases, but is concerned that the new procedures do not go far enough. The employee is required to attempt to contact the taxpayer only "where the employee believes there is insufficient data in the case to make a determination." The problem with this approach is that until he or she speaks to the taxpayer, the employee may not realize that the available information is insufficient or incomplete. A conversation with the taxpayer may change the preliminary analysis or confirm what the employee already knows. Either way, if the employee speaks to the taxpayer, that employee is more likely to arrive at the correct tax result, have an opportunity to educate the taxpayer, and resolve the case in a timely manner.

<sup>36</sup> For an in-depth discussion of this issue, see Most Serious Problem: *The IRS Does Not Sufficiently Recognize and Address Domestic Violence and Abuse and its Effects on Tax Administration*, *supra*.

## Recommendations

The National Taxpayer Advocate recommends that the IRS:

1. 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.
2. Revise the IRM to require employees to attempt personal contact with the taxpayer before making final determinations in all innocent spouse cases.

## 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

### RESPONSIBLE OFFICIALS

Richard E. Byrd Jr., Commissioner, Wage and Investment Division  
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 Terry Milholland, Chief Technology Officer

### DEFINITION OF PROBLEM

The IRS's miscalculations of interest can lead taxpayers to pay the balances shown on official IRS documents, only to later receive additional bills for accruals of interest, or to pay incorrect amounts without ever knowing the IRS made a mistake. As the National Taxpayer Advocate reported in 2008, the IRS has had particular difficulty with "restricted" interest, which IRS computers cannot calculate automatically.<sup>1</sup> Since the 2008 report, the IRS has significantly improved its processes to avoid restricted interest computation errors.<sup>2</sup> While the IRS reported a restricted interest error rate of more than 30 percent in 2008, the current error rate is only about five percent.<sup>3</sup> The National Taxpayer Advocate commends the IRS for this progress, and looks forward to continued improvement in the accuracy of interest computations with the release of the IRS's Customer Account Data Engine (CADE 2).<sup>4</sup>

However, two problems persist:

- The computation of the underlying failure-to-pay (FTP) penalty may be erroneous, which may in turn cause inaccurate interest calculations. As the National Taxpayer Advocate reported, computer-generated miscalculations of FTP penalties could potentially affect two million taxpayer accounts.<sup>5</sup>

<sup>1</sup> National Taxpayer Advocate 2008 Annual Report to Congress 304, 307. We use the terms "manual interest," "restricted interest," and "complex interest" interchangeably to refer to interest that requires manual computation because it is limited to specific time periods or rates (or is prohibited altogether) pursuant to various statutory provisions. See Internal Revenue Manual (IRM) 20.2.8.1 (Dec. 4, 2009).

<sup>2</sup> Moreover, because the IRS previously used a flawed method of evaluating the accuracy of restricted interest calculations, the 2008 error rate may have been overstated. Prior to December 2010, the IRS's sampling methods were not statistically valid. Small Business/Self-Employed (SB/SE) Research, Project # PHL0075, *Profile and Sampling Method for Complex Interest Cases*, Final Report (Feb. 2011).

<sup>3</sup> National Taxpayer Advocate 2008 Annual Report to Congress 308; SB/SE Research, Project # PHL0075, *Profile and Sampling Method for Complex Interest Cases*, Final Report (Feb. 2011); IRS Financial & Management Controls Executive Steering Committee (FMC-ESC) Briefing to the GAO 3 (June 2011) (reporting a 95 percent accuracy rate). Some improvements are attributable to better measurement of the quality of restricted interest computations.

<sup>4</sup> CADE 2 is a modern database that will ultimately replace the IRS's more than 50-year-old return and data processing systems. IRS, CADE 2 Overview Briefing 5 (Sept. 2011).

<sup>5</sup> National Taxpayer Advocate 2008 Annual Report to Congress 304, 306; IRC § 6651.

- Contrary to law, taxpayers whose accounts have restricted interest do not always receive statements showing accumulated interest until several years have passed and the balance has grown to unmanageable proportions.<sup>6</sup>

## ANALYSIS OF PROBLEM

### Background

Under Internal Revenue Code (IRC) § 6601, taxpayers must pay interest on tax that is not paid when due. Under IRC § 6611, the government pays interest on taxpayers' overpayments.<sup>7</sup> In many instances, interest begins to accrue with reference to the due date of the return or the date of the overpayment, and continues to accrue without interruption until the tax or refund is paid. However, various statutory provisions scattered throughout the IRC restrict the accrual of interest to certain periods or suspend it altogether.<sup>8</sup> When IRS computer systems cannot identify and accommodate these situations, IRS employees must compute restricted interest manually.<sup>9</sup>

*Example: IRC § 7508 - Combat Zone*<sup>10</sup>

IRC § 7508 prescribes a period of time to be disregarded when determining the interest accrual and penalties for individuals who serve in a combat zone. The period starts when a taxpayer enters the zone and ends 180 days after he or she leaves it. The IRS also disregards any time spent in a hospital due to injuries sustained in a combat zone when computing an interest liability. The interest due from these taxpayers must be manually computed.

Each year, as required by IRC § 7524, the IRS sends an updated balance due statement, which includes any penalty and interest, to taxpayers whose accounts do not have restricted interest computations, whether or not there have been any payments or credits to the account.<sup>11</sup> However, when the account involves restricted interest, and there is no payment or credit to trigger the necessary manual computation, the taxpayer may not

<sup>6</sup> IRC § 7524 provides "Not less than annually, the Secretary shall send a written notice to each taxpayer who has a delinquent tax account of the amount of the tax delinquency as of the date of the notice." IRS Notice CP 71, *Reminder Notice*, when issued to taxpayers whose accounts have restricted interest, states "penalty and interest are *not* calculated to the date shown above, if a payoff is required, please call the telephone number shown." (Emphasis added.) IRM 3.14.1.7.7.5.11 (Jan. 1, 2011). Only if the taxpayer calls the IRS and requests it will the IRS mail a statement that shows the full amount, including interest, due from the taxpayer.

<sup>7</sup> Interest is imposed with reference to a principal amount, which, pursuant to IRC § 6601(e)(2)(A), may include penalties and additions to tax.

<sup>8</sup> See IRM Exhibit 20.2.8-1 (Dec. 4, 2009) for a table of these statutory provisions.

<sup>9</sup> As the General Accounting Office (GAO, now the Government Accountability Office) initially described the problem, "some interest is calculated manually or on personal computers because the capability to calculate interest in accordance with certain legal requirements has not been programmed into systems at IRS' primary computing center. IRS refers to this interest as restricted interest because the accounts it relates to have been restricted from the automatic interest calculations that most accounts are subject to." GAO, GAO/AIMD-94-22, *Important IRS Revenue Information Is Unavailable or Unreliable* 27 (Dec. 21, 1993).

<sup>10</sup> IRC § 7508; IRM 20.2.7.7 (Mar. 9, 2010).

<sup>11</sup> See also IRM 21.3.1.4.44 (Oct. 1, 2002). The annual notice is referred to as a "reminder notice."

receive periodic statements of the total amount owed.<sup>12</sup> A restricted interest account with a large tax liability accruing interest over a year (or multiple years) can create an unexpected financial burden for the taxpayer.<sup>13</sup>

### **The General Accounting Office Identified Problems with IRS Interest Computations in 1993.**

In 1993, the General Accounting Office (GAO, now the Government Accountability Office) found that errors in manual interest computations produced inaccurate data that in turn caused unreliable revenue information.<sup>14</sup> In the 2008 Annual Report to Congress, the National Taxpayer Advocate reported the manual interest computation accuracy rate for the first half of fiscal year (FY) 2008 was 67.7 percent.<sup>15</sup> In 2009, the GAO reported the problem had not been fully addressed.<sup>16</sup>

### **A Multifaceted Approach Led to Significant Improvements.**

The IRS's Office of Servicewide Interest (OSI), embedded in the Small Business /Self-Employed division, sets IRS policy and procedures for calculation and application of interest, including restricted interest. In response to the 67.7 percent reported accuracy, OSI created the Complex Interest Quality Management System (CIQMS) unit to sample manual complex interest transactions, review them for accuracy, and report on the weaknesses.<sup>17</sup> OSI monitors the monthly sampling reviews to identify error trends and correct them. For example, OSI sends a letter to any examiner who performed an erroneous computation and to the employee's manager, advising of the error.<sup>18</sup> Other measures the IRS has taken to improve the accuracy of restricted interest computations include onsite and ongoing training and assistance, software upgrades such as Automated Computation Tools, and consistent use of the software by all restricted interest analysts.<sup>19</sup>

<sup>12</sup> See GAO, GAO/AIMD-94-22, *Important IRS Revenue Information Is Unavailable or Unreliable* 27 (Dec. 21, 1993) ("Further, restricted interest included in reported accounts receivable information is understated, because it is not routinely updated. Instead, individual accounts are updated only as needed, for example, when a payment is made against a taxpayer account").

<sup>13</sup> IRM 5.19.10.5.7 (Sept. 15, 2010). Several examples of Systemic Advocacy Management System (SAMS) complaints relating to this IRS deficiency are on file with TAS.

<sup>14</sup> GAO, GAO/AIMD-94-22, *Important IRS Revenue Information Is Unavailable or Unreliable* 26-29 (Dec. 21, 1993) (noting "IRS has identified its difficulty in properly calculating restricted interest as a problem since 1986 when it was identified as a material weakness in IRS' annual report on internal controls required by the Federal Managers' Financial Integrity Act").

<sup>15</sup> National Taxpayer Advocate 2008 Annual Report to Congress 304-315. See also Memo from IRS Deputy Commissioner, Services and Enforcement, to Deputy Commissioners "Training and Assistance" (July 10, 2008), on file with TAS.

<sup>16</sup> GAO, GAO-09-514, *Status of GAO Financial Audit and Related Financial Management Report Recommendations*, Appendix I (June 2009) ("While IRS has undertaken several actions to strengthen controls over this area, such as updating guidance and providing training related to manual interest calculations, it has yet to develop a sampling methodology to monitor the accuracy of its manual interest computation and assess the effectiveness of its corrective action.").

<sup>17</sup> SB/SE Research Final Report, # PHL0075, *Profile and Sampling Method for Complex Interest Cases* 7 (Feb. 2011).

<sup>18</sup> IRS Financial & Management Controls Executive Steering Committee (FMC-ESC) Briefing to the GAO (June 2011). OSI plans to expand its future sampling to areas identified as having the largest potential for improving manual interest computations.

<sup>19</sup> *Id.* The Decision Modeling, Inc./Automated Computation Tool, also known as DMI/ACT, is software that allows the user to efficiently import taxpayer data from other databases in order to compute restricted interest.

Because a recurring audit issue for the GAO was that the sampling method used to select cases for review was neither statistically valid nor systematic, the OSI asked SB/SE to develop a valid systematic sampling process that the GAO would accept.<sup>20</sup> OSI began using the new sampling method in December 2010 and found that the accuracy rate stood at 95 percent.<sup>21</sup> OSI reported this development to the GAO, which in turn closed the issue as having been effectively addressed.<sup>22</sup> The National Taxpayer Advocate is pleased with the IRS's success in addressing the longstanding concerns surrounding restricted interest accuracy computations.

### FTP Penalty Miscalculations Continue to Cause Problems.

TAS continues to find interest errors attributable to miscalculation of the underlying FTP penalty.<sup>23</sup> A TAS research study published in the 2008 Annual Report to Congress found that computer-generated miscalculations of FTP penalties could potentially affect about two million taxpayer accounts. The statistically valid study found the IRS systemically charged some FTP penalties that exceeded the maximum rate of 25 percent, in direct violation of IRC § 6651, and overcharged taxpayers who were entitled to a reduced FTP penalty rate because they had entered into installment agreements.<sup>24</sup> If a miscalculated penalty is assessed against the taxpayer, the amount of interest owed may also be misstated. The IRS is in the process of correcting penalty miscalculations that trigger interest miscalculations, but some problems remain.<sup>25</sup>

### CADE 2 Is Expected to Resolve Many Computational Problems.

Beginning January 2012, the IRS will roll out an extensive system modernization known as CADE 2, that will permit the Individual Master File (IMF) to accept and post taxpayer account updates every business day. Instead of waiting two weeks for payments to post,

<sup>20</sup> SB/SE Research Final Report, # PHL0075, *Profile and Sampling Method for Complex Interest Cases* (Feb. 2011). The new process called for monthly samples of manual interest transactions from four categories: IMF (open), IMF (closed), BMF (open), and BMF (closed). IMF refers to Individual Master File, the IRS database on which the IRS stores individual taxpayers' data. BMF refers to Business Master File, the database on which the IRS stores business taxpayers' data. "Open" cases are those that will have further interest computations. "Closed" cases are those with a final interest computation.

<sup>21</sup> IRS Financial & Management Controls Executive Steering Committee (FMC-ESC) Briefing to the GAO 3 (June 2011).

<sup>22</sup> GAO, GAO-11-536, *Status of GAO Financial Audit and Related Financial Management Report Recommendations* Appendix I (June 2011) ("IRS has undertaken several actions to strengthen controls over this area, such as updating guidance, implementing standardized software to aid in the computation of manually calculated interest, and providing training related to manual interest calculations. We verified that IRS began testing samples of manual interest transactions in fiscal year 2011, making statistically valid projections of the results, and evaluating the results to gauge the effectiveness of its actions."):

<sup>23</sup> The IRS asserts the FTP penalty when taxpayers fail to fully pay their taxes on or before the due dates of their tax returns. Under IRC § 6651(a), the IRS imposes the penalty rate of 0.5 percent per month, up to a maximum of 25 percent where there is: 1) a failure to pay tax shown on a return, which is calculated from the original due date of the return; or 2) a failure to pay any tax required to be reported on a return that was not reported on the return, and for which the IRS has issued a notice and demand (this penalty does not apply if the amount shown in the notice and demand is paid within 21 calendar days from the date of the notice and demand (or within ten business days if the total balance due is \$100,000 or more). The IRS calculates this penalty from the date that is 21 calendar days, or ten business days, if applicable, after the notice and demand for payment was issued.)

<sup>24</sup> National Taxpayer Advocate 2008 Annual Report to Congress 304, 306.

<sup>25</sup> IRS response to TAS initial draft (Oct. 24, 2011). For example, IRM 20.1.2.2.4 (Apr. 19, 2011) explains how to compute a deficiency under IRC § 6211(b) (4) when a taxpayer claims certain refundable credits in excess of the total tax. The FTP penalty in those cases must be manually computed. IRM 20.1.2.1.5 (3) (Apr. 19, 2011).

it will only take from 48 hours to a week.<sup>26</sup> Ultimately, CADE 2 will replace the more than 50-year-old system the IRS now uses to process tax return data. The new database and its related applications will, over time, replace the IMF and BMF as the IRS system of record for taxpayer accounts and will speed the transition from the multiple systems that now manage taxpayer accounts to one comprehensive system. The OSI anticipates that the January 2012 release of CADE 2 and the availability of real-time data will eliminate some account restricting for interest and certain interest accruals, and will increase timeliness of taxpayer account data.<sup>27</sup> For this reason, it is important that CADE 2 continue to develop, roll out, and operate as planned.

## CONCLUSION

The IRS has an obligation to protect the integrity of taxpayer accounts by accurately calculating interest. While the IRS has significantly improved its restricted interest program, other problems still cause interest miscalculations. Moreover, taxpayers whose accounts have restricted interest do not always receive a notice that states the total amount they owe. In conclusion, the National Taxpayer Advocate offers these preliminary recommendations:

1. Address inaccurately computed FTP penalties that impact corresponding interest computations in the next CADE 2 release; and
2. Notify taxpayers of updated restricted interest balances at least twice each year.

## IRS COMMENTS

The IRS agrees with the importance of ensuring notices to taxpayers contain accurate penalty and interest computations and has taken several steps over the years to this end. The IRS developed statistically valid monthly samples of manual interest transactions for an ongoing review by the Complex Interest Quality Measurement System function to measure the effectiveness of actions taken to improve interest accuracy. The IRS completed the review of the first statistically valid sample of manual interest transactions reporting a 95 percent accuracy rate for FY 2010.

In 2011, the GAO reviewed the accomplishments of the IRS and the results achieved through the first quarter of FY 2011. With the review process documenting the positive impact of the actions taken to improve the accuracy of Manual Interest computations, GAO acknowledged the IRS has taken several actions to strengthen controls over manual interest

<sup>26</sup> See IRS, *Cade 2 Modernizes IRS System for Taxpayer Accounts* (Aug. 29, 2011), available at <http://irweb.irs.gov/AboutIRS/Nwsctr/Headlines/28279.aspx>.

<sup>27</sup> For example, IRC § 6611(e)(1) prohibits the IRS from paying interest on overpayments if a refund is made within 45 days after the due date the return, or 45 days after the return was filed, if the return was filed after its due date. The more often the IRS can process refund claims within these timeframes, the more often it can avoid paying interest on overpayments.

accuracy.<sup>28</sup> In addition, to ensure our employees have the knowledge and skills to perform accurate manual interest computations, the IRS has:

- Developed, updated, and disseminated guidance in the Internal Revenue Manual.
- Developed and provided Restricted Interest training courses for the computational units throughout the IRS.
- Provided training assistance through our Office of Servicewide Interest to the computational units throughout the IRS.

The IRS also has made programming changes to correct Failure to Pay penalty systemic calculations. In the report, the National Taxpayer Advocate mentions an issue, referencing the 2008 report, where the FTP was systemically charged above the 25 percent maximum rate and, for taxpayers entering into installment agreements, was not systemically computed at the appropriate reduced rate. These issues were both corrected. A programming change was implemented to prevent FTP penalties charges from exceeding the 25 percent maximum rate. A recent review performed by the Office of Servicewide Penalties showed that the accuracy of assessed FTP penalty has consistently been better than 99 percent. Programming changes were also made to ensure qualifying taxpayers received a reduced failure to pay penalty rate if entered into an installment agreement. In fact, in June of 2010, GAO closed its recommendation with regard to ensuring qualified taxpayers received the reduced FTP penalty rate confirming the accuracy of these computations.<sup>29</sup>

In compliance with the Internal Revenue Code,<sup>30</sup> the IRS mails an annual reminder notice of delinquent tax to taxpayers with balances due, including penalties and interest. However, in certain cases the law for restricted interest is so complex that restricted interest must be calculated manually and the interest amount cannot be systemically printed on the notice. For the few cases where a manual interest computation is required, taxpayers are provided a contact number in the notice for obtaining a detailed computation and pay-off amount.<sup>31</sup> We provide this contact number so taxpayers can be informed of the exact amount owed including interest.

The National Taxpayer Advocate makes two preliminary recommendations to improve the accuracy of calculating interest. IRS is taking, or has taken, the following actions with respect to these recommendations.

The IRS agrees to continue devoting resources toward planning and programming for its systems to resolve any remaining penalty and interest computation issues including FTP

<sup>28</sup> GAO, GAO-11-536, *Status of GAO Financial Audit and Related Financial Management Report Recommendations*, Appendix I (June 2011).

<sup>29</sup> GAO, GAO-10-597, *Status of GAO Recommendations from Internal Revenue Service Financial Audits and Related Management Reports*, Issue 09-01, 62.

<sup>30</sup> IRC § 7524, Annual Notice of Tax Delinquency. Not less often than annually, the Secretary shall send a written notice to each taxpayer who has a tax delinquent account of the amount of the tax delinquency as of the date of the notice.

<sup>31</sup> IRM 3.14.1.7.7.5.11 (Jan. 1, 2011).

penalties that impact corresponding interest computations. These efforts include improvements made during a future iteration of CADE 2.

With regard to the National Taxpayer Advocate's recommendation to notify taxpayers of updated restricted interest balances at least twice each year, this would dramatically increase the volume for the print sites that currently send notices annually and would result in inconsistent treatment compared with other taxpayers. Taxpayers without restricted interest only receive an annual notice. At this time, given current resources limitations, we do not anticipate sending semi-annual notices.

### Taxpayer Advocate Service Comments

The National Taxpayer Advocate congratulates the IRS on its progress in addressing interest accuracy and FTP penalty miscomputations. She applauds the IRS's commitment to work toward resolving, in a future CADE 2 release, remaining penalty miscomputations that lead to interest miscalculations. Accordingly, we find our first preliminary recommendation is satisfied. However, the National Taxpayer Advocate is concerned about the IRS's insistence that providing taxpayers with a contact number they can call to obtain pay-off amounts is sufficient to notify taxpayers of the amount they owe.<sup>32</sup> A taxpayer may very well respond to such a notice by paying the dollar amount shown on the notice. If the taxpayer does not realize that dollar amount did not include interest, he or she will be surprised to receive another notice the following year advising that a balance is still outstanding. Even if the taxpayer understands the notice did not include all interest on the liability, he or she may be surprised at the impact interest has on the calculation of the debt.<sup>33</sup> In either situation, an additional year of interest will have accrued on the outstanding balance by the time the taxpayer receives the next reminder notice – which again may not show all the interest owed. Finally, displaying the actual interest accruals in notices may incentivize taxpayers to pay the IRS debt before paying lower-interest debts.

The IRS raises two objections to the preliminary recommendation that the IRS notify taxpayers of updated restricted interest balances at least twice each year. After noting that the cases requiring manual computation are “few,” the first objection is that semi-annual notices would “dramatically” increase the volume for print sites that send the notices. The second objection is that providing semi-annual notices to taxpayers whose accounts have restricted

<sup>32</sup> See, e.g., IRC § 6631, which provides, “The Secretary shall include with each notice to an individual taxpayer which includes an amount of interest required to be paid by such taxpayer under this title information with respect to the section of this title under which the interest is imposed and a computation of the interest.” The provision is based on Congress' belief that “taxpayers should be provided the detail to support the amount of interest charged by the IRS. The computation of interest is a complex calculation, often involving multiple interest rates. The Committee believes that it is appropriate to require the IRS to give notice to the taxpayer that interest is being charged, how it is calculated, and the total amount of the interest.” S. Rep. No. 105-174 (1998) 66, accompanying H.R. 2676, IRS Restructuring and Reform Act of 1998, Tit. III, D. Notice of Interest Charges.

<sup>33</sup> Interest generally accrues on delinquent tax accounts at the federal short-term rate plus three percentage points, is *compounded daily*, and applies to penalties and interest as well as the outstanding tax balance itself. IRC §§ 6621, 6622.

interest would afford them different treatment compared to taxpayers whose accounts do not have restricted interest.

With respect to the second objection, it is already the case that the IRS treats taxpayers whose accounts have restricted interest differently from taxpayers whose accounts do not have restricted interest. The annual notice to taxpayers with restricted interest may not reflect the amount they actually owe, while the notice to taxpayers without restricted interest shows their entire liability. Moreover, taxpayers whose accounts do not have restricted interest can immediately obtain an accurate statement of the balance due, either by calling the IRS or going in person to a Taxpayer Assistance Center, but neither of these options is available to taxpayers whose accounts have restricted interest.<sup>34</sup> Nevertheless, we will accommodate the IRS's inclination to treat taxpayers consistently, and now recommend that taxpayers with restricted interest receive at least *annual* notices showing the entire amount they owe, including restricted interest. This would put taxpayers with restricted interest on the same footing as taxpayers who do not, and would require fewer resources than semi-annual notices would consume.

## Recommendation

Notify taxpayers, in writing, of the entire amount they owe, including restricted interest, at least annually.

<sup>34</sup> An IRS Customer Service Representative must request a qualified analyst to compute the taxpayer's balance. See IRM 20.2.3.5 (2) (Nov. 18, 2008).

## Introduction: Legislative Recommendations

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 chart immediately following this Introduction summarizes congressional action on legislative recommendations the National Taxpayer Advocate proposed in her 2001 through 2010 Annual Reports to Congress.<sup>1</sup> 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 has an opportunity to receive and consider a taxpayer perspective. The following discussion details recent developments relating to the National Taxpayer Advocate's proposals.

### Eliminate Tax Strategy Patents

In 2007, the National Taxpayer Advocate recommended eliminating tax strategy patents because they grant private citizens monopolies on the application of our tax laws.<sup>2</sup> Allowing taxpayers to obtain these patents misleads taxpayers into believing the government has approved a patented tax strategy, increases the cost of tax compliance and advice, and undermines congressionally-created tax incentives. In 2011, Congress passed the Leahy-Smith America Invents Act, which eliminates patents for any strategy seeking to reduce, avoid, or defer tax liability.<sup>3</sup>

### Increase Compliance and Oversight of Federal Return Preparers

In 2003, the National Taxpayer Advocate recommended a number of changes to impose an effective penalty regime on return preparers. Among proposals for Earned Income Tax Credit (EITC) penalty reform and due diligence requirements, the National Taxpayer Advocate recommended a tiered penalty structure for preparers violating the EITC due diligence requirements, with penalties of \$100 for any occurrences during the first year, \$500 for those during the second year, and \$1,000 for those during the third year. The United States-Korea Free Trade Agreement Implementation Act, which became law in 2011, increased the maximum amount of the EITC due diligence penalty for return preparers to \$500 for returns required to be filed after December 31, 2011.<sup>4</sup>

<sup>1</sup> An electronic version of the chart is available on the TAS website at <http://www.irs.gov/advocate>.

<sup>2</sup> National Taxpayer Advocate 2007 Annual Report to Congress 512-524.

<sup>3</sup> Pub. L. No. 112-29, § 14(a), 125 Stat. 284, 327 (2011).

<sup>4</sup> Pub. L. No. 112-41, § 501, 125 Stat. 428, 459 (2011). The Taxpayer Advocacy and Government Accountability Promotion Act of 2011, S. 1289, 112th Cong. (2011), discussed *infra*, also proposed raising the EITC due diligence penalty to \$500.

## Introduction: Legislative Recommendations

**Repeal the Alternative Minimum Tax for Individuals**

The National Taxpayer Advocate has advocated for changes to the Alternative Minimum Tax (AMT) numerous times since her first Annual Report to Congress in 2001. Although the AMT initially was enacted to prevent wealthy taxpayers from avoiding tax, the AMT now affects many middle-class taxpayers, significantly increasing their tax liabilities and imposing burden on them to calculate the AMT correctly under a complex set of rules. The AMT was the number one Most Serious Problem in the National Taxpayer Advocate's 2003 and 2006 Annual Reports to Congress.<sup>5</sup> The National Taxpayer Advocate recommended repealing the AMT for individuals in her Annual Reports to Congress in 2001, 2004, 2008, and again in 2010, as part of fundamental tax reform.<sup>6</sup> Numerous bills introduced in 2011 would repeal the AMT entirely, either for individuals or for both individuals and corporations.<sup>7</sup> The Fair and Simple Tax Act of 2011<sup>8</sup> calls for indexing the AMT for inflation, and the Tax Relief Certainty Act of 2011<sup>9</sup> would phase in increases in the AMT exemption amount between 2011 and 2021 and make offsets against the AMT for certain nonrefundable tax credits permanent.

**Simplify the Tax Code**

The National Taxpayer Advocate has made numerous recommendations in her Annual Reports to Congress to simplify the tax code, including recommendations regarding the family status provisions,<sup>10</sup> education tax incentives,<sup>11</sup> retirement savings incentives,<sup>12</sup> phase-out provisions,<sup>13</sup> sunsets,<sup>14</sup> overall tax reform,<sup>15</sup> providing taxpayers with a pre-populated

<sup>5</sup> National Taxpayer Advocate 2003 Annual Report to Congress 5-19 (Most Serious Problem: *Alternative Minimum Tax for Individuals*); National Taxpayer Advocate 2006 Annual Report to Congress 3-5 (Most Serious Problem: *Alternative Minimum Tax for Individuals*). In both reports, the National Taxpayer Advocate identified the lack of adjustment for inflation as one of the problems with the AMT.

<sup>6</sup> National Taxpayer Advocate 2001 Annual Report to Congress 166-178 (Legislative Recommendation: *Alternative Minimum Tax for Individuals*); National Taxpayer Advocate 2004 Annual Report to Congress 383-385 (Legislative Recommendation: *Alternative Minimum Tax*); National Taxpayer Advocate 2008 Annual Report to Congress 356-362 (Legislative Recommendation: *Repeal the Alternative Minimum Tax for Individuals*); National Taxpayer Advocate 2010 Annual Report to Congress 368-369 (Legislative Recommendation: *Enact Tax Reform Now*). The National Taxpayer Advocate has also testified before both houses of Congress on problems created by the AMT. See *Alternative Minimum Tax: Hearing Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways & Means* (Mar. 7, 2007) (statement of Nina E. Olson, National Taxpayer Advocate); *Blowing the Cover on the Stealth Tax: Exposing the Individual AMT: Hearing Before the Subcomm. on Taxation and IRS Oversight of the Senate Comm. on Finance* (May 23, 2005) (statement of Nina E. Olson, National Taxpayer Advocate).

<sup>7</sup> See S. 727, 112th Cong. (2011); S. 820, 112th Cong. (2011); H.R. 86, 112th Cong. (2011); H.R. 547, 112th Cong. (2011); H.R. 3400, 112th Cong. (2011). Both Senate bills propose repealing the AMT for individual and corporate taxpayers, while the three House bills would repeal the AMT only for individuals.

<sup>8</sup> H.R. 99, 112th Cong. (2011).

<sup>9</sup> S. 336, 112th Cong. (2011); H.R. 696, 112th Cong. (2011).

<sup>10</sup> See, e.g., National Taxpayer Advocate 2008 Annual Report to Congress 363-369 (Legislative Recommendation: *Simplify the Family Status Provisions*).

<sup>11</sup> See *id.* at 370-372 (Legislative Recommendation: *Simplify and Streamline Education Tax Incentives*).

<sup>12</sup> See *id.* at 373-374 (Legislative Recommendation: *Simplify and Streamline Retirement Savings Tax Incentives*).

<sup>13</sup> See *id.* at 410-413 (Legislative Recommendation: *Eliminate (or Simplify) Phase-Outs*).

<sup>14</sup> See National Taxpayer Advocate 2008 Annual Report to Congress 397-409 (Legislative Recommendation: *Eliminate (or Reduce) Procedural Incentives for Lawmakers to Enact Tax Sunsets*).

<sup>15</sup> See *Tax Reform: Hearing Before the H. Comm. on Ways and Means* (Jan. 20, 2011) (statement of Nina E. Olson, National Taxpayer Advocate); *Complexity and the Tax Gap: Making Tax Compliance Easier and Collecting What's Due: Hearing Before the S. Comm. on Finance* (June 28, 2011) (statement of Nina E. Olson, National Taxpayer Advocate); National Taxpayer Advocate 2010 Annual Report to Congress 365-372 (Legislative Recommendation: *Enact Tax Reform Now*).

return,<sup>16</sup> and providing taxpayers with an itemized receipt to show how their tax dollars are spent.<sup>17</sup>

The Bipartisan Tax Fairness and Simplification Act of 2011 generally incorporates many of these recommendations.<sup>18</sup> The bill would combine current education-related tax credits and deductions into a single tax credit for all education expenses, including tuition, fees, and student loan interest.<sup>19</sup> It would consolidate retirement savings plans into one category.<sup>20</sup> It would eliminate many sunsets created by the Economic Growth and Tax Relief Reconciliation Act of 2001<sup>21</sup> by permanently repealing phase-out provisions for the EITC, the dependent care credit, the child tax credit, personal exemptions, and limitations on itemized deductions.<sup>22</sup> It would further simplify the tax code by reducing the number of tax preferences.<sup>23</sup> In addition to general simplification provisions, the bill would make the return filing process easier for taxpayers by providing any taxpayer, upon request, with a simplified pre-prepared tax return based on the information the IRS has received from third parties.<sup>24</sup> Taxpayers also would receive a one-page summary showing how the most recently available fiscal year's revenue was spent.<sup>25</sup>

### Reduce the Tax Gap to Promote Tax Fairness

The National Taxpayer Advocate has made numerous recommendations to reduce the tax gap, which is important to ensure that compliant taxpayers are not effectively required to subsidize noncompliance by others. The Taxpayer Advocacy and Government Accountability Promotion Act of 2011 (also known as the "TAX GAP Act") includes many of the National Taxpayer Advocate's recommendations.<sup>26</sup> In 2007, The National Taxpayer Advocate focused on the portion of the tax gap associated with the cash economy<sup>27</sup> and recommended requiring financial institutions to report all bank accounts to the IRS, thus eliminating the \$10 interest reporting threshold currently required by IRC § 6049(a).<sup>28</sup> The

<sup>16</sup> See Most Serious Problem: *Accelerated Third-Party Information Reporting and Pre-Populated Returns Would Reduce Taxpayer Burden and Benefit Tax Administration*, *supra*.

<sup>17</sup> See National Taxpayer Advocate 2010 Annual Report to Congress at 368.

<sup>18</sup> S. 727, 112th Cong. (2011).

<sup>19</sup> *Id.* at § 114.

<sup>20</sup> *Id.* at § 112.

<sup>21</sup> Pub. L. No. 107-16, 115 Stat. 38 (2001).

<sup>22</sup> S. 727, 112th Cong. §§ 103-106 (2011).

<sup>23</sup> *Id.* at §§ 107 & 115.

<sup>24</sup> *Id.* at § 116.

<sup>25</sup> *Id.* The National Taxpayer Advocate recommended a summary be given to each taxpayer presenting a general breakdown of how federal dollars are spent. National Taxpayer Advocate 2010 Annual Report to Congress 368 (Legislative Recommendation: *Enact Tax Reform Now*).

<sup>26</sup> S. 1289, 112th Cong. (2011).

<sup>27</sup> "Cash economy" refers to income from legal activities that is not reported to the IRS by third parties. National Taxpayer Advocate 2007 Annual Report to Congress vi, fn. 1.

<sup>28</sup> National Taxpayer Advocate 2007 Annual Report to Congress 501-502 (Legislative Recommendation: *Measures to Address Noncompliance in the Cash Economy*).

## Introduction: Legislative Recommendations

TAX GAP Act would remove this minimum interest requirement.<sup>29</sup> Also related to reporting information, the Act would adopt the National Taxpayer Advocate's recommendation to revise Form 1040, Schedule C by breaking out income that is not reported on information returns.<sup>30</sup>

In 2007, the National Taxpayer Advocate recommended that Congress give the National Taxpayer Advocate the authority to make *de minimis* apology payments to taxpayers when the action or inaction of the IRS has caused excessive expense or undue burden to the taxpayer and the taxpayer meets the significant hardship definition in IRC § 7811.<sup>31</sup> Such payments could improve voluntary compliance by promoting greater public confidence in the fairness of the tax system. These payments would be excluded from gross income, and the National Taxpayer Advocate could include a summary of any payments granted in the preceding year in her Annual Report to Congress to provide Congress with more information about areas in which the IRS is imposing undue expense or burden on taxpayers. The TAX GAP Act would give the National Taxpayer Advocate this authority and require the National Taxpayer Advocate to summarize all apology payments granted in her Annual Report to Congress.<sup>32</sup> In addition, the bill would require the Secretary of the Treasury to submit to Congress a report on the apology payments program not later than December 31, 2013.<sup>33</sup>

Another way to improve tax compliance is to reduce the number of misclassified workers. In 2008, the National Taxpayer Advocate highlighted that the misclassification of employees as independent contractors has a significant revenue impact due to the comparatively limited information reporting and tax withholding requirements for many self-employed workers.<sup>34</sup> Among a suite of recommendations, the National Taxpayer Advocate proposed that Congress direct the Treasury Department and the Joint Committee on Taxation to report on the operation of the revised worker classification rules and provide recommendations to increase compliance.<sup>35</sup> The TAX GAP Act would require the Treasury Department to submit to Congress two reports on worker classification for each fiscal year, one focusing on examinations of employers and the other providing statistical estimates of the number of misclassified workers and the impact on the employment tax gap.<sup>36</sup>

The TAX GAP Act also encourages revenue collection by promoting collection alternatives. The National Taxpayer Advocate has long advocated for more widespread access to collec-

<sup>29</sup> S. 1289, 112th Cong. § 303(a) (2011).

<sup>30</sup> *Id.* at § 201(a). National Taxpayer Advocate 2004 Annual Report to Congress 488 (Legislative Recommendation: *Tax Gap Recommendations*); National Taxpayer Advocate 2010 Annual Report to Congress 40 (Most Serious Problem: *The Cash Economy*).

<sup>31</sup> National Taxpayer Advocate 2007 Annual Report to Congress 480 (Legislative Recommendation: *Taxpayer Bill of Rights and De Minimis "Apology Payments"*).

<sup>32</sup> S. 1289, 112th Cong. § 107 (2011).

<sup>33</sup> *Id.*

<sup>34</sup> National Taxpayer Advocate 2008 Annual Report to Congress 375 (Legislative Recommendation: *Worker Classification*).

<sup>35</sup> *Id.* at 376.

<sup>36</sup> S. 1289, 112th Cong. § 703 (2011).

tion alternatives for taxpayers who cannot pay their liabilities in full upon assessment.<sup>37</sup> The TAX GAP Act would enact her 2006 recommendation to eliminate the 20 percent down payment requirement for lump-sum offers-in-compromise.<sup>38</sup>

Another provision of the TAX GAP Act would require any return that is prepared electronically but filed on paper to contain a matrix code or 2D barcode that could convert the return to an electronic format when scanned.<sup>39</sup> The National Taxpayer Advocate previously proposed 2D bar-coding as a possible bridge for taxpayers who are reluctant to file electronically.<sup>40</sup>

### Promote Awareness of and Access to Low Income Taxpayer Clinics (LITCs)

The National Taxpayer Advocate has repeatedly stressed the importance of LITCs and has asked the IRS to promote the services of LITCs and educate taxpayers about their existence.<sup>41</sup> The version of the FY 2012 Financial Services and General Government Appropriations bill approved by the Senate Appropriations Committee contained a provision that would have authorized the IRS to refer taxpayers to specific LITCs.<sup>42</sup>

### Legislative Recommendations Advanced by Administrative or Judicial Actions

In 2002 and in subsequent reports, the National Taxpayer Advocate recommended that Congress regulate federal income tax return preparers.<sup>43</sup> In 2009 and 2010, the IRS on its own established a framework to regulate paid tax return preparers. In 2011, all tax return preparers were required for the first time to register with the IRS, and preparers other than attorneys, CPAs and Enrolled Agents, generally will be required to pass a competency exam and take annual continuing education courses. Because approximately 60 percent of taxpayers use paid preparers, this is a significant achievement that should go a long

<sup>37</sup> See, e.g., National Taxpayer Advocate 2006 Annual Report to Congress 507-519 (Legislative Recommendation: *Improve Offer in Compromise Eligibility*).

<sup>38</sup> S. 1289, 112th Cong. § 103 (2011). National Taxpayer Advocate 2006 Annual Report to Congress 507-519 (Legislative Recommendation: *Improve Offer in Compromise Eligibility*). A lump-sum offer is one in which all payments would be made in five or fewer installments. IRC § 7122(c).

<sup>39</sup> S. 1289, 112th Cong. § 204 (2011).

<sup>40</sup> National Taxpayer Advocate 2004 Annual Report to Congress 101-102 (Most Serious Problem: *Electronic Return Preparation and Filing*).

<sup>41</sup> See, e.g., National Taxpayer Advocate 2007 Annual Report to Congress 551-553.

<sup>42</sup> S. 1573, 112th Cong. Title I (2011).

<sup>43</sup> See Status Update: *The IRS Has Made Significant Progress in Developing and Implementing a System to Register and Test Return Preparers*, supra; National Taxpayer Advocate 2009 Annual Report to Congress 41-69 (Most Serious Problem: *The IRS Lacks a Servicewide Return Preparer Strategy*); National Taxpayer Advocate 2008 Annual Report to Congress 423-427 (Legislative Recommendation: *The Time Has Come to Regulate Federal Tax Return Preparers*); National Taxpayer Advocate 2006 Annual Report to Congress 197-221 (Most Serious Problem: *Oversight of Unenrolled Return Preparers*); National Taxpayer Advocate 2005 Annual Report to Congress 223-237 (Most Serious Problem: *Regulation of Electronic Return Originators*); National Taxpayer Advocate 2004 Annual Report to Congress 67-88 (Most Serious Problem: *Oversight Of Unenrolled Return Preparers*); National Taxpayer Advocate 2003 Annual Report to Congress 270-301 (Legislative Recommendation: *Federal Tax Return Preparers Oversight And Compliance*); National Taxpayer Advocate 2002 Annual Report to Congress 216-230 (Legislative Recommendation: *Regulation of Federal Tax Return Preparers*); see also *Fraud in Income Tax Return Preparation: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 109th Cong. (2005) (statement of Nina E. Olson, National Taxpayer Advocate).

## Introduction: Legislative Recommendations

way toward both protecting taxpayers from unscrupulous and incompetent preparers and improving return accuracy.<sup>44</sup>

In 2006 and 2010, the National Taxpayer Advocate recommended that Congress overturn a two-year limitation imposed by regulation on the right of taxpayers to obtain equitable innocent spouse relief.<sup>45</sup> In July 2011, the Commissioner announced that the IRS will no longer apply the two-year limit to equitable innocent spouse relief requests.<sup>46</sup> In general, married taxpayers who file joint tax returns are jointly and severally liable for their tax liabilities, but a taxpayer may qualify for an exception pursuant to the “innocent spouse” rules. Under the two-year limitation, many taxpayers who otherwise qualified for equitable innocent spouse relief were not able to obtain it because they did not know the IRS had initiated collection activity until after more than two years had passed.

In 2009, the National Taxpayer Advocate recommended that Congress direct the Treasury Department to prepare a report identifying the administrative and legislative steps required to allow the IRS to receive and process information reporting documents before it processes tax returns.<sup>47</sup> In April 2011, the Commissioner announced that this will become a major IRS initiative.<sup>48</sup>

In 2010, the National Taxpayer Advocate recommended that Congress require the redaction of third-party return information in proceedings relating to whistleblower claims. The intent was to ensure that the confidential tax return information of taxpayers who are the subject in whistleblower claims is adequately protected.<sup>49</sup> In December 2011, the U.S. Tax Court announced proposed amendments to its Rules of Practice and Procedure that would, among other things, provide privacy protections in whistleblower cases.<sup>50</sup> In the Tax Court’s explanation for the proposed change relating to whistleblower cases, the National Taxpayer Advocate’s concerns were noted and discussed in detail.<sup>51</sup>

<sup>44</sup> *Hearing on Return Preparation Program Before the U.S. House Comm. On Ways and Means, Subcommittee on Oversight 5* (Written Statement of David R. Williams, Director, Return Preparer Office, IRS) (July 28, 2011).

<sup>45</sup> National Taxpayer Advocate 2010 Annual Report to Congress 377-382 (Legislative Recommendation: *Allow Taxpayers to Request Equitable Relief Under Internal Revenue Code Section 6015(f) or 66(c) at Any Time Before Expiration of the Period of Limitations on Collection and to Raise Innocent Spouse Relief as a Defense in Collection Actions*); National Taxpayer Advocate 2006 Annual Report to Congress 540-541 (Legislative Recommendation: *Eliminate the Two-Year Limitation Period for Taxpayers Seeking Equitable Relief under IRC §§ 6015 or 66*).

<sup>46</sup> See IRS News Release, IR-2011-80, *Two-Year Limit No Longer Applies to Many Innocent Spouse Requests* (July 25, 2011).

<sup>47</sup> National Taxpayer Advocate 2009 Annual Report to Congress 338-345 (Legislative Recommendation: *Direct the Treasury Department to Develop a Plan to Reverse the “Pay Refunds First, Verify Eligibility Later” Approach to Tax Return Processing*).

<sup>48</sup> IRS News Release, IR-2011-38, Prepared Remarks of IRS Commissioner Doug Shulman at the National Press Club (April 6, 2011), available at <http://www.irs.gov/newsroom/article/0,,id=238204,00.html>.

<sup>49</sup> National Taxpayer Advocate 2010 Annual Report to Congress 396-399 (Legislative Recommendation: *Protect Taxpayer Privacy in Whistleblower Cases*).

<sup>50</sup> See new proposed rule 345, in which a whistleblower can proceed anonymously in the Tax Court, and the name, address, and other identifying information of the taxpayer to which the whistleblower claim relates must be redacted.

<sup>51</sup> See United States Tax Court, Press Release (Dec. 28, 2011), available at <http://www.ustaxcourt.gov/press/122811.pdf>.

## Summary of 2011 Legislative Recommendations

We continue to advocate for the proposals we have made previously. In this report, we highlight some of the recommendations made in previous reports that will protect taxpayer rights. In addition, we present 13 new legislative recommendations, which are summarized below.

- 1. Enact Previous Recommendations of the National Taxpayer Advocate to Protect Taxpayer Rights.** 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, taxpayer rights must be a priority. The National Taxpayer Advocate urges Congress to enact the legislative recommendations detailed in previous annual reports, beginning with the 2007 recommendation to codify a taxpayer bill of rights (TBOR) that would explicitly detail the rights and responsibilities of taxpayers. The proposed TBOR includes the following rights: the right to be informed; the right to be assisted; the right to be heard; the right to pay no more than the correct amount of tax; the right of appeal; the right to certainty; the right to privacy; the right to confidentiality; the right to representation; and the right to a fair and just tax system. Proposed taxpayer responsibilities include: the obligation to be honest; the obligation to be cooperative; the obligation to provide accurate information and documents on time; the obligation to keep records; and the obligation to pay taxes on time.
- 2. Restrict Access to the Death Master File.** Earlier in this report, the National Taxpayer Advocate recognized identity theft as one of the Most Serious Problems affecting taxpayers. In a relatively new tactic, some identity thieves are filing tax returns that claim the dependency exemption and various tax credits using the Social Security number (SSN) of deceased individuals. The Social Security Administration's "Death Master File" (DMF) provides the public with easy access to SSNs and other personal information of the deceased. The National Taxpayer Advocate recommends that Congress enact legislation to restrict access to certain personally identifiable information in the DMF and outlines several options for doing so. Congress could create an exemption under the Freedom of Information Act; it could adopt the approach it uses to govern the confidentiality and disclosure of tax return information; or it could mandate that a truncated version of the SSN (*e.g.*, only the last four digits) be included in the DMF to prevent the theft and misuse of the decedents' identities.
- 3. Mandate that the IRS, in Conjunction with the National Taxpayer Advocate, Review Any Proposed Expanded Math Error Authority to Protect Taxpayer Rights.** IRC §§ 6213(b) and (g) authorize the IRS to use its math error authority to summarily assess tax and bypass normal deficiency procedures. Originally, math error authority was intended to apply only to simple mathematical and clerical errors, but over the years, Congress has expanded its use to a compliance context. To ensure that IRS use of math error authority does not impair taxpayers' rights and minimizes burden to both the taxpayer and the IRS, 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 limit any future expansion 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 or weigh the adequacy of information. Finally, the National Taxpayer Advocate recommends that Congress restrict math error authority in situations with a high abatement rate.

- 4. Clarify that the Scope and Standard of Tax Court Determinations Under IRC § 6015(f) Is *De Novo*.** Married taxpayers who file joint returns are jointly and severally liable for any deficiency or unpaid tax. An “innocent spouse” statute, IRC § 6015, provides for relief from deficiencies in specific circumstances, and “equitable” relief under IRC § 6015(f) when relief is not otherwise available under IRC § 6015. Equitable relief under IRC § 6015(f) is appropriate when, taking into account all the facts and circumstances, it would be inequitable to hold the taxpayer liable for the deficiency or unpaid tax. The Tax Court has held that the scope and standard of 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 it will consider the case anew, without deference to the agency determination to deny relief. The IRS disagrees with the Tax Court’s opinions and maintains that the scope of the Tax Court’s review is limited to the administrative record, and the proper standard of review is abuse of discretion. The IRS’s position is especially harmful to taxpayers who cannot afford representation or assistance during administrative proceedings, or those who are victims of domestic violence or abuse. The divergence between Counsel’s position and that of the Tax Court creates uncertainty for taxpayers and consumes administrative and judicial resources. The National Taxpayer Advocate recommends that Congress amend IRC § 6015 to specify 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.** The IRS should generally reserve levy actions for situations where a taxpayer is unwilling to cooperate or comply. Yet longstanding IRS regulations under IRC § 6343(a) relieve individuals, but not businesses, from levies on the grounds of economic hardship, leading the IRS to use levies in lieu of collection alternatives. The National Taxpayer Advocate recommends that Congress amend IRC § 6343(a)(1)(D) to: permit the IRS, in its discretion, to release a levy against the taxpayer’s property or rights to property if the IRS determines that the satisfaction of the levy is creating an economic hardship due to the financial condition of the taxpayer’s business; and require the IRS, in making the determination to release a levy against a business on economic hardship grounds, to consider 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, as well as whether the taxes could be collected from a responsible person under an IRC § 6672 Trust Fund Recovery Penalty assessment.

6. **Amend the Erroneous Refund Penalty to Permit Relief in Case of Reasonable Cause for Claim to Refundable Credits.** 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 special tax breaks are refundable credits commonly known as “negative taxes” targeted at small business, low and middle-income taxpayers, who may be challenged by the complexity of the tax law. Misunderstanding the rules may leave these taxpayers charged with a penalty of a fifth of their denied claim, even if they started with no taxable income from which to pay. 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. The National Taxpayer Advocate recommends that Congress amend the erroneous refund penalty under IRC § 6676 to permit relief from a penalty for erroneously claiming a refund for a refundable credit if the taxpayer acted with reasonable cause and in good faith.
7. **Authorize the IRS Office of Appeals to Rescind Notices of Determination Issued in Collection Due Process Cases.** Before the IRS can seize a taxpayer’s assets or after it has filed a Notice of Federal Tax Lien (NFTL) against the taxpayer, 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 request. After a hearing, Appeals issues a notice of determination (NOD), giving the taxpayer 30 days to petition the Tax Court for review. Appeals officers are not required to review or consider information submitted by the taxpayer after Appeals issues the NOD. In some cases, Appeals issues a NOD before the taxpayer has had an opportunity to present information. Yet the Code does not authorize Appeals to rescind CDP NODs or rehear issues. The National Taxpayer Advocate recommends that Congress amend IRC § 6330 to permit the IRS Office of 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.
8. **Clarify that the Emergency Exception to the Anti-Deficiency Act Includes IRS Activities that Protect Taxpayer Life and Property.** When the appropriation of funds for a federal agency for a fiscal year expires without a continuing resolution or new appropriation for the current fiscal year, the Anti-Deficiency Act generally prohibits the agency from incurring obligations to pay its employees. An agency cannot employ the personal services of its employees even without incurring obligations to pay them, but with an important exception: for emergencies involving the safety of human life or the protection of property. The National Taxpayer Advocate believes that two IRS contingency shutdown plans, developed in 2011 in anticipation of lapses in appropriations, would prevent it from assisting taxpayers even in emergencies involving the safety of

human life or the protection of property. The National Taxpayer Advocate's authority to issue Taxpayer Assistance Orders pursuant to IRC § 7811 does not explicitly include the authority to incur obligations in advance of appropriations and thus may not compensate for the current inability to assist taxpayers. 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.** A small segment of the tax return preparer community defrauds taxpayers and the IRS by altering taxpayers' returns without their knowledge. In these schemes, the preparers completed and taxpayers signed correct tax returns that claimed refunds, but the preparers later altered the returns without the taxpayers' knowledge to claim increased refunds that the taxpayers were not entitled to receive. The preparers filed the altered returns with the IRS, which either remitted the inflated refunds to the preparers, who deposited the amounts shown on the correct returns into taxpayers' bank accounts and deposited the excess into their own accounts, or split the refund between the preparer's and taxpayer's bank accounts, as indicated on the return. In these cases, the IRS may penalize the preparer, but the amount of any penalty is generally far below the amount of the refund received by the preparer. Moreover, the government must file a costly suit in court to collect the excess refund from the preparer. The National Taxpayer Advocate recommends that Congress amend the 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.
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."** When an organization's exempt status under IRC § 501(c)(3) is revoked, the organization becomes subject to tax and its donors can no longer deduct their contributions. The Pension Protection Act of 2006 (PPA) imposed a new annual filing requirement on small exempt organizations and provides that the exempt status of any exempt organization failing to file for three consecutive years is *automatically* revoked. The PPA does not prohibit administrative review of an IRS conclusion of automatic revocation. However, the IRS declines to provide such a review, and advises taxpayers to contact the IRS, or to apply for reinstatement by filling out a full Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, which the IRS estimates takes *more than two weeks* to complete. The National Taxpayer Advocate makes the following recommendations

to Congress: require the IRS to allow administrative review of its conclusion that an organization's exempt status was automatically revoked; require the IRS to develop a Form 1023-EZ; and require and provide sufficient funding for the IRS to implement Cyber Assistant for use in preparing applications for recognition of exempt status.

11. **Allow Individual U.S. Taxpayers Residing Abroad the Option to Choose the Currency of Their Country of Residence as Their Functional Currency.** For millions of U.S. taxpayers living abroad, the measurement of U.S. taxable income may be complicated and distorted when those taxpayers receive income or pay expenses in a foreign currency. Current law requires taxpayers to make all federal income tax determinations in their functional currencies, which is generally the U.S. dollar for individual U.S. taxpayers. This requirement raises two problems. First, taxpayers receiving payments in a foreign currency must translate into dollars all the income they receive and all the deductible expenses they pay in the foreign currency, using the prevailing exchange rate as of the date each item of income or expense is paid, received, or accrued. Second, currency fluctuations may create capital gains even on routine personal transactions. The National Taxpayer Advocate recommends that Congress amend IRC § 985 to allow individual U.S. taxpayers residing abroad to elect to use the currency of their country of residence (or "tax home" as defined for the purposes of IRC § 911) as their functional currency, giving individuals the flexibility currently extended to business taxpayers.
12. **Codify the Authority of the Office of the Taxpayer Advocate to File Amicus Briefs, Comment on Regulations, and Issue Taxpayer Advocate Directives.** The National Taxpayer Advocate is required to assist taxpayers in resolving problems with the IRS, to identify areas where frequent problems occur or that are the frequent subject of litigation, and to identify administrative and legislative solutions. Despite these mandates, the National Taxpayer Advocate is not authorized to participate in litigation. Issues of interest to numerous taxpayers may come before the judiciary or arise in proposed regulations with no one representing the rights of taxpayers in general. In the course of assisting taxpayers or identifying frequent problems, the National Taxpayer Advocate uses her authority to issue Taxpayer Advocate Directives (TADs) that direct IRS units to change procedures to protect the rights of taxpayers, prevent undue burden, ensure equitable treatment, or provide an essential service. However, the IRS may not comply with or even respond to a Taxpayer Advocate Directive because it comes not under a statute but merely a delegated power that the Commissioner could revoke.

The National Taxpayer Advocate recommends that Congress authorize the National Taxpayer Advocate to appoint an independent Counsel to the National Taxpayer Advocate, who shall report directly to the National Taxpayer Advocate. The National Taxpayer Advocate should have the authority to submit *amicus curiae* briefs in federal appellate litigation on matters relating to the protection of taxpayer rights that the National Taxpayer Advocate has identified as a Most Litigated Issue or Most Serious Problem. Further, Congress should require the IRS to submit proposed and temporary

regulations to and receive comments from the Office of the Taxpayer Advocate within a reasonable time and address those comments in the preamble to such regulations. The National Taxpayer Advocate recommends that Congress grant the National Taxpayer Advocate nondelegable authority to issue a TAD 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, and require that, to object to a TAD, the IRS would have to respond timely in writing. Finally, Congress should amend IRC § 7811 to require the IRS to raise its objections to a Taxpayer Assistance Order issued by the National Taxpayer Advocate by responding in writing within a reasonable time, as established by the National Taxpayer Advocate in the Order.

- 13. Appoint an IRS Historian.** From time to time, the IRS undertakes initiatives to improve tax administration, with both successes and failures. Generally, federal laws require retention of and access to IRS and other government records, but no law requires IRS publication of history and no unit of the IRS is charged with recording these events. Thoughtful study of history can help accomplish a mission because understanding agency origins and development aids in comprehending the present situation and illuminates possible future directions. Knowledge of history can prevent the IRS from repeating past efforts that proved fruitless. The National Taxpayer Advocate recommends that Congress create a permanent position within the IRS for a historian with expertise in federal taxation as well as archival methods. Congress should mandate that the IRS historian record history objectively, accurately, and without deletion. To ensure historical expertise regardless of contemporary IRS policies, the National Taxpayer Advocate recommends that the historian be appointed by the Secretary of the Treasury in consultation with the Archivist of the United States.

## National Taxpayer Advocate Legislative Recommendations with Congressional Action

## National Taxpayer Advocate Legislative Recommendations with Congressional Action

| Alternative Minimum Tax (AMT)   |             |                          |            |  |
|---|-------------|--------------------------|------------|--|
| <b>Repeal the Individual AMT</b>  |             |                          |            |  |
| National Taxpayer Advocate 2001 Annual Report to Congress 82-100;<br>National Taxpayer Advocate 2004 Annual Report to Congress 383-385;<br>National Taxpayer Advocate 2008 Annual Report to Congress 356-362. |             | Repeal the AMT outright. |            |  |
|   | Bill Number | Sponsor                  | Date       | Status   |
| Legislative Activity 112th Congress   | HR 86       | Bachmann                 | 1/5/2011   | Referred to Ways & Means Committee   |
|   | HR 99       | Dreler                   | 1/5/2011   | Referred to Ways & Means Committee   |
|   | HR 547      | Garrett                  | 2/8/2011   | Referred to Ways & Means Committee   |
|   | HR 3400     | Garrett                  | 11/10/2011 | Referred to Ways & Means Committee   |
|   | S 727       | Wyden                    | 4/5/2011   | Referred to the Finance Committee  |
|   | S 820       | Shelby                   | 4/14/2011  | Referred to the Finance Committee  |
| Legislative Activity 111th Congress   | S 3018      | Wyden                    | 2/23/2010  | Referred to the Finance Committee  |
|   | HR 240      | Garrett                  | 1/7/2009   | Referred to the Ways & Means Committee   |
|   | HR 782      | Paul                     | 1/28/2009  | Referred to the Ways & Means Committee   |
|   | S 932       | Shelby                   | 4/30/2009  | Referred to the Finance Committee  |
| Legislative Activity 110th Congress   | S 55        | Baucus                   | 1/4/2007   | Referred to the Finance Committee  |
|   | S 14        | Kyl                      | 4/17/2007  | Referred to the Finance Committee  |
|   | S 1040      | Shelby                   | 3/29/2007  | Referred to the Finance Committee  |
|   | HR 1365     | English                  | 3/7/2007   | Referred to the Ways & Means Committee   |
|   | HR 1942     | Garrett                  | 4/19/2007  | Referred to the Ways & Means Committee   |
|   | HR 3970     | Rangel                   | 10/25/2007 | Referred to the Ways & Means Committee   |
|   | S 2293      | Lott                     | 11/1/2007  | Placed on the Senate Legislative Calendar under General Orders. Calendar No. 464 |
| Legislative Activity 109th Congress   | HR 1186     | English                  | 3/9/2005   | Referred to the Ways & Means Committee   |
|   | S 1103      | Baucus                   | 5/23/2005  | Referred to the Finance Committee  |
|   | HR 2950     | Neal                     | 6/16/2005  | Referred to the Ways & Means Committee   |
|   | HR 3841     | Manzullo                 | 9/2/2005   | Referred to the Ways & Means Committee   |
| Legislative Activity 108th Congress   | HR 43       | Collins                  | 1/7/2003   | Referred to the Ways & Means Committee   |
|   | HR 1233     | English                  | 3/12/2003  | Referred to the Ways & Means Committee   |
|   | S 1040      | Shelby                   | 5/12/2003  | Referred to the Finance Committee  |
|   | HR 3060     | N. Smith                 | 9/10/2003  | Referred to the Ways & Means Committee   |
|   | HR 4131     | Houghton                 | 4/2/2004   | Referred to the Ways & Means Committee   |
|   | HR 4164     | Shuster                  | 4/2/2004   | Referred to the Ways & Means Committee   |
| Legislative Activity 107th Congress   | HR 437      | English                  | 2/6/2001   | Referred to the Ways & Means Committee   |
|   | S 616       | Hutchison                | 3/26/2002  | Referred to the Finance Committee  |
|   | HR 5166     | Portman                  | 7/18/2002  | Referred to the Ways & Means Committee   |

## National Taxpayer Advocate Legislative Recommendations with Congressional Action

|   |        |   |                |                                   |   |
|---|--------|---|----------------|-----------------------------------|---|
| <b>Index AMT for Inflation</b>                                      |        |   |                |                                   |   |
| National Taxpayer Advocate 2001 Annual Report to Congress 82-100.   |        | If full repeal of the individual AMT is not possible, it should be indexed for inflation.   |                |                                   |   |
|   |        | <b>Bill Number</b>  | <b>Sponsor</b> | <b>Date</b>                       | <b>Status</b>   |
| Legislative Activity 111th Congress                                 |        | S 3223  | McConnell      | 9/13/2010                         | Placed on the Senate Calendar   |
|   |        | HR 5077   | Hall           | 4/20/2010                         | Referred to the Ways & Means Committee  |
|   |        | HR 719  | Lee            | 1/27//2009                        | Referred to the Ways & Means Committee  |
|   |        | S 722   | Baucus         | 3/26/2009                         | Referred to the Finance Committee   |
| Legislative Activity 110th Congress                                 |        | HR 1942   | Garrett        | 4/19/2007                         | Referred to the Ways & Means Committee  |
| Legislative Activity 109th Congress                                 |        | HR 703  | Garrett        | 2/9/2005                          | Referred to the Ways & Means Committee  |
|   |        | HR 4096   | Reynolds       | 10/20/2005                        | 12/7/2005-Passed the House;<br>12/13/2005-Placed on the Senate Legislative Calendar |
| Legislative Activity 108th Congress                                 |        | HR 22   | Houghton       | 1/7/2003                          | Referred to the Ways & Means Committee  |
| Legislative Activity 107th Congress                                 |        | HR 5505   | Houghton       | 10/1/2002                         | Referred to the Ways & Means Committee  |
| <b>Eliminate Several Adjustments for Individual AMT</b>             |        |   |                |                                   |   |
| National Taxpayer Advocate 2001 Annual Report to Congress 82-100.   |        | Eliminate personal exemptions, the standard deduction, deductible state and local taxes, and miscellaneous itemized deductions as adjustment items for individual AMT purposes.   |                |                                   |   |
|   |        | <b>Bill Number</b>  | <b>Sponsor</b> | <b>Date</b>                       | <b>Status</b>   |
| Legislative Activity 112th Congress                                 |        | S 336   | DeMint         | 2/14/2011                         | Referred to the Finance Committee   |
| Legislative Activity 110th Congress                                 |        | S 102   | Kerry          | 1/4/2007                          | Referred to the Finance Committee   |
| Legislative Activity 109th Congress                                 |        | S 1861  | Harkin         | 10/7/2005                         | Referred to the Finance Committee   |
| Legislative Activity 108th Congress                                 |        | HR 1939   | Neal           | 5/12/2003                         | Referred to the Ways & Means Committee  |
| <b>Private Debt Collection (PDC)</b>                                |        |   |                |                                   |   |
| <b>Repeal PDC Provisions</b>  |        |   |                |                                   |   |
| National Taxpayer Advocate 2006 Annual Report to Congress 458-462.  |        | Repeal IRC § 6306, thereby terminating the PDC initiative.  |                |                                   |   |
|   |        | <b>Bill Number</b>  | <b>Sponsor</b> | <b>Date</b>                       | <b>Status</b>   |
| Legislative Activity 111th Congress                                 |        | HR 796  | Lewis          | 2/3/2009                          | Referred to the Ways & Means Committee  |
| Legislative Activity 110th Congress                                 |        | HR 5719   | Rangel         | 4/16/2008                         | Referred to the Finance Committee   |
|   |        | S 335   | Dorgan         | 1/18/2007                         | Referred to the Finance Committee   |
|   |        | HR 695  | Van Hollen     | 1/24/2007                         | Referred to the Ways & Means Committee  |
|   |        | HR 3056   | Rangel         | 7/17/2007                         | 10/10/2007-Passed the House;<br>10/15/2007 Referred to the Finance Committee        |
| <b>Tax Preparation and Low Income Taxpayer Clinics (LITC)</b>       |        |   |                |                                   |   |
| <b>Matching Grants for LITC for Return Preparation</b>              |        |   |                |                                   |   |
| National Taxpayer Advocate 2002 Annual Report to Congress vii-viii. |        | Create a grant program for return preparation similar to the LITC grant program. The program should be designed to avoid competition with VITA and should support the IRS's goal (and need) to have returns electronically filed. |                |                                   |   |
| Legislative Activity 111th Congress                                 |        | <b>Pub. L. No. 111-117, Div. C, Title I, 123 Stat. 3034, 3163 (2009).</b>   |                |                                   |   |
| Legislative Activity 110th Congress                                 |        | <b>Pub. L. No. 110-161, Div. D, Title I, 121 Stat. 1975, 1976 (2007).</b>   |                |                                   |   |
|   |        | <b>Bill Number</b>  | <b>Sponsor</b> | <b>Date</b>                       | <b>Status</b>   |
|   |        | HR 5716   | Becerra        | 4/8/2008                          | Referred to the Ways & Means Committee  |
|   |        | S 1219  | Bingaman       | 4/25/2007                         | Referred to the Finance Committee   |
|   | S 1967 | Clinton   | 8/2/2007       | Referred to the Finance Committee |   |

National Taxpayer Advocate Legislative Recommendations with Congressional Action

|   |                    |  |             |   |
|---|--------------------|--|-------------|---|
| Legislative Activity 109th Congress   | HR 894             | Becerra  | 2/17/2005   | Referred to the Financial Institutions and Consumer Credit Subcommittee   |
|   | S 832              | Bingaman   | 4/18/2005   | Referred to the Finance Committee   |
|   | S 1321             | Santorum   | 6/28/2005   | 9/15/2006-Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title; with S. Rep. No. 109-336<br>9/15/2006-Placed on the Senate Legislative Calendar under General Orders. Calendar No. 614    |
| Legislative Activity 108th Congress   | S 476              | Grassley   | 2/27/2003   | Referred to the Finance Committee   |
|   | S 685              | Bingaman   | 3/21/2003   | Referred to the Finance Committee   |
|   | S 882              | Baucus   | 4/10/2003   | 5/19/2004-S 882 was incorporated into HR 1528 as an amendment and HR 1528 passed in lieu of S 882   |
|   | HR 1661            | Rangel   | 4/8/2003    | Referred to the Ways & Means Committee  |
|   | HR 3983            | Becerra  | 3/17/2004   | Referred to the Ways & Means Committee  |
| Legislative Activity 107th Congress   | HR 586             | Lewis  | 2/13/2001   | 4/18/2002-Passed the House with an amendment; referred to the Senate  |
|   | HR 3991            | Houghton   | 3/19/2001   | Referred to the Ways & Means Committee  |
|   | HR 7               | Baucus   | 7/16/2002   | Reported by Chairman Baucus with an amendment; referred to the Finance Committee  |
| <p><b>Regulation of Income Tax Return Preparers</b></p> <p>National Taxpayer Advocate 2002 Annual Report to Congress 216-230; National Taxpayer Advocate 2003 Annual Report to Congress 270-301; National Taxpayer Advocate 2007 Annual Report to Congress 83-95 &amp; 140-155; National Taxpayer Advocate 2008 Annual Report to Congress 423-426; National Taxpayer Advocate 2009 Annual Report to Congress 41-69.</p> |                    | <p>Create an effective oversight and penalty regime for return preparers by taking the following steps:</p> <ul style="list-style-type: none"> <li>◆ Enact a registration, examination, certification, and enforcement program for federal tax return preparers;</li> <li>◆ Direct the Secretary of the Treasury to establish a joint task force to obtain accurate data about the composition of the return preparer community and make recommendations about the most effective means to ensure accurate and professional return preparation and oversight;</li> <li>◆ Require the Secretary of the Treasury to study the impact cross-marketing tax preparation services with other consumer products and services has on the accuracy of returns and tax compliance; and</li> <li>◆ Require the IRS to take steps within its existing administrative authority, including requiring a check-box on all returns in which preparers would enter their category of return preparer (i.e., attorney, CPA, enrolled agent, or unenrolled preparer) and developing a simple, easy-to-read pamphlet for taxpayers that explains their protections.</li> </ul> |             |   |
| Legislative Activity 111th Congress   | <b>Bill Number</b> | <b>Sponsor</b>   | <b>Date</b> | <b>Status</b>   |
|   | S 3215             | Bingaman   | 4/15/2010   | Referred to the Finance Committee   |
| Legislative Activity 110th Congress   | HR 5047            | Becerra  | 4/15/2010   | Referred to the Ways & Means Committee  |
|   | HR 5716            | Becerra  | 4/8/2008    | Referred to the Ways & Means Committee  |
| Legislative Activity 109th Congress   | S 1219             | Bingaman   | 4/25/2007   | Referred to the Finance Committee   |
|   | HR 894             | Becerra  | 2/17/2005   | Referred to the Financial Institutions and Consumer Credit Subcommittee   |
| Legislative Activity 108th Congress   | S 832              | Bingaman   | 4/18/2005   | Referred to the Finance Committee   |
|   | S 1321             | Santorum   | 6/28/2005   | 9/15/2006-Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title; with written report No. 109-336<br>9/15/2006-Placed on Senate Legislative Calendar under General Orders; Calendar No. 614 |
|   | S 685              | Bingaman   | 3/21/2003   | Referred to the Finance Committee   |
| Legislative Activity 108th Congress   | S 882              | Baucus   | 4/10/2003   | 5/19/2004-S 882 was incorporated into HR 1528 as an amendment and HR 1528 passed in lieu of S 882   |
|   | HR 3983            | Becerra  | 3/17/2004   | Referred to the Ways & Means Committee  |

## National Taxpayer Advocate Legislative Recommendations with Congressional Action

|  |  |   |                     |             |  |
|--|--|---|---------------------|-------------|--|
| <b>Referrals to LITCs</b>  |  |   |                     |             |  |
| National Taxpayer Advocate 2007 Annual Report to Congress 551-553. |  | Amend IRC § 7526(c) to add a special rule stating that notwithstanding any other provision of law, IRS employees may refer taxpayers to LITCs receiving funding under this section. This change will allow IRS employees to refer a taxpayer to a specific clinic for assistance. |                     |             |  |
|  |  | <b>Bill Number</b>  | <b>Sponsor</b>      | <b>Date</b> | <b>Status</b>  |
| Legislative Activity 112th Congress                                |  | S 1573  | Durbin              | 9/15/2011   | Placed on the Senate Legislative Calendar under General Orders. Calendar No. 171   |
| Legislative Activity 111th Congress                                |  | HR 4994   | Lewis               | 4/13/2010   | Referred to the Ways & Means Committee   |
|  |  | S 3215  | Bingaman            | 4/15/2010   | Referred to the Finance Committee  |
|  |  | HR 5047   | Becerra             | 4/15/2010   | Referred to the Ways & Means Committee   |
| Legislative Activity 110th Congress                                |  | HR 5719   | Rangel              | 4/16/2008   | Referred to the Finance Committee  |
| <b>Public Awareness Campaign on Registration Requirements</b>      |  |   |                     |             |  |
| National Taxpayer Advocate 2002 Annual Report to Congress 216-230. |  | Authorize the IRS to conduct a public information and consumer education campaign, utilizing paid advertising, to inform the public of the requirements that paid preparers must sign the return prepared for a fee and display registration cards.                               |                     |             |  |
|  |  | <b>Bill Number</b>  | <b>Sponsor</b>      | <b>Date</b> | <b>Status</b>  |
| Legislative Activity 111th Congress                                |  | S 3215  | Bingaman            | 4/15/2010   | Referred to the Finance Committee  |
|  |  | HR 5047   | Becerra             | 4/15/2010   | Referred to the Ways & Means Committee   |
| Legislative Activity 110th Congress                                |  | HR 5716   | Becerra             | 4/8/2008    | Referred to the Ways & Means Committee   |
|  |  | S 1219  | Bingaman            | 4/25/2007   | Referred to the Finance Committee  |
| Legislative Activity 109th Congress                                |  | HR 894  | Becerra             | 2/17/2005   | Referred to the Financial Institutions and Consumer Credit Subcommittee  |
|  |  | S 832   | Bingaman            | 4/18/2005   | Referred to the Finance Committee  |
|  |  | S 1321  | Santorum            | 6/28/2005   | 9/15/2006-Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title; with S. Rep. No. 109-336<br>9/15/2006-Placed on the Senate Legislative Calendar under General Orders; Calendar No. 614 |
| Legislative Activity 108th Congress                                |  | S 685   | Bingaman            | 3/21/2003   | Referred to the Finance Committee  |
|  |  | S 882   | Baucus              | 4/10/2003   | 5/19/2004-S 882 was incorporated into HR 1528 as an amendment and HR 1528 passed in lieu of S 882  |
|  |  | HR 3983   | Becerra             | 3/17/2004   | Referred to the Ways & Means Committee   |
| <b>Increase Preparer Penalties</b>                                 |  |   |                     |             |  |
| National Taxpayer Advocate 2003 Annual Report to Congress 270-301. |  | Strengthen oversight of all preparers by enhancing due diligence and signature requirements, increasing the dollar amount of preparer penalties, and assessing and collecting those penalties, as appropriate.  |                     |             |  |
| Legislative Activity 112th Congress                                |  | <b>Pub. L. No. 112-41 § 501, 125 Stat. 428, 459 (2011).</b>   |                     |             |  |
|  |  | <b>Bill Number</b>  | <b>Sponsor</b>      | <b>Date</b> | <b>Status</b>  |
| Legislative Activity 111th Congress                                |  | S 3215  | Bingaman            | 4/15/2010   | Referred to the Finance Committee  |
|  |  | HR 5047   | Becerra             | 4/15/2010   | Referred to the Ways & Means Committee   |
| Legislative Activity 110th Congress                                |  | HR 5719   | Rangel              | 4/16/2008   | Referred to the Finance Committee  |
|  |  | HR 4318   | Crowley/<br>Ramstad | 12/6/2007   | Referred to the Ways & Means Committee   |
|  |  | S 2851  | Bunning             | 4/14/2008   | Referred to the Finance Committee  |
|  |  | S 1219  | Bingaman            | 4/25/2007   | Referred to the Finance Committee  |

## National Taxpayer Advocate Legislative Recommendations with Congressional Action

|   |   |                       |             |   |
|---|---|-----------------------|-------------|---|
| Legislative Activity 109th Congress   | HR 894  | Becerra               | 2/17/2005   | Referred to the Financial Institutions and Consumer Credit Subcommittee   |
|   | S 832   | Bingaman              | 4/18/2005   | Referred to the Finance Committee   |
|   | S 1321  | Santorum              | 6/28/2005   | 9/15/2006–Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336<br>9/15/2006–Placed on Senate Legislative Calendar under General Orders; Calendar No. 614 |
| Legislative Activity 108th Congress   | S 685   | Bingaman              | 3/21/2003   | Referred to the Finance Committee   |
|   | S 882   | Baucus                | 4/10/2003   | 5/19/2004–S 882 was incorporated into HR 1528 as an amendment and HR 1528 passed in lieu of S 882   |
|   | HR 3983   | Becerra               | 3/17/2004   | Referred to the Ways & Means Committee  |
| <b>Refund Delivery Options</b><br>National Taxpayer Advocate 2008 Report to Congress 427 - 441.   | Direct the Department of the Treasury and the IRS to (1) minimize refund turnaround times; (2) implement a Revenue Protection Indicator; (3) develop a program to enable unbanked taxpayers to receive refunds on stored value cards (SVCs); and (4) conduct a public awareness campaign to disseminate accurate information about refund delivery options. |                       |             |   |
| Legislative Activity 111th Congress   | <b>Bill Number</b>  | <b>Sponsor</b>        | <b>Date</b> | <b>Status</b>   |
|   | S 3215  | Bingaman              | 4/15/2010   | Referred to the Ways & Means Committee  |
|   | HR 5047   | Becerra               | 4/15/2010   | Referred to the Senate Finance Committee  |
|   | HR 4994   | Lewis                 | 4/13/2010   | Referred to the Ways & Means Committee  |
| <b>Small Business Issues</b>  |   |                       |             |   |
| <b>Health Insurance Deduction/Self-Employed Individuals</b><br>National Taxpayer Advocate 2001 Annual Report to Congress 223.<br>National Taxpayer Advocate 2008 Annual Report to Congress 388-389. | Allow self-employed taxpayers to deduct the costs of health insurance premiums for purposes of self-employment taxes.   |                       |             |   |
| Legislative Activity 111th Congress   | <b>Pub. L. No. 111-124, § 2041 STAT 2560 (2010).</b>  |                       |             |   |
|   | <b>Bill Number</b>  | <b>Sponsor</b>        | <b>Date</b> | <b>Status</b>   |
|   | S 725   | Bingaman              | 3/26/2009   | Referred to the Finance Committee   |
|   | HR 1470   | Kind                  | 3/12/2009   | Referred to the Ways & Means Committee  |
| Legislative Activity 110th Congress   | S 2239  | Bingaman              | 10/25/2007  | Referred to the Finance Committee   |
| Legislative Activity 109th Congress   | S 663   | Bingaman              | 3/17/2005   | Referred to the Finance Committee   |
|   | S 3857  | Smith                 | 9/16/2006   | Referred to the Finance Committee   |
| Legislative Activity 108th Congress   | HR 741  | Sanchez               | 2/12/2003   | Referred to the Ways & Means Committee  |
|   | HR 1873   | Manzullo<br>Velazquez | 4/30/2003   | Referred to the Ways & Means Committee  |
| Legislative Activity 107th Congress   | S 2130  | Bingaman              | 4/15/2002   | Referred to the Finance Committee   |
| <b>Married Couples as Business Co-owners</b><br>National Taxpayer Advocate 2002 Annual Report to Congress 172-184.  | Amend IRC § 761(a) to allow a married couple operating a business as co-owners to elect out of subchapter K of the IRC and file one Schedule C (or Schedule F in the case of a farming business) and two Schedules SE if certain conditions apply.  |                       |             |   |
| Legislative Activity 110th Congress   | <b>Pub.L. No. 110-28, Title VIII, § 8215, 121 Stat. 193, 194 (2007).</b>  |                       |             |   |
| Legislative Activity 109th Congress   | <b>Bill Number</b>  | <b>Sponsor</b>        | <b>Date</b> | <b>Status</b>   |
|   | HR 3629   | Doggett               | 7/29/2005   | Referred to the Ways & Means Committee  |
|   | HR 3841   | Manzullo              | 9/2/2005    | Referred to the Ways & Means Committee  |

## National Taxpayer Advocate Legislative Recommendations with Congressional Action

|   |  |   |             |  |
|---|--|---|-------------|--|
| Legislative Activity 108th Congress   | HR 1528  | Portman   | 6/20/2003   | 5/19/2004–Passed/agreed to in Senate, with an amendment  |
|   | S 842  | Kerry   | 4/9/2003    | Referred to the Finance Committee  |
|   | HR 1640  | Udall   | 4/3/2003    | Referred to the Ways & Means Committee   |
|   | HR 1558  | Doggett   | 4/2/2003    | Referred to the Ways & Means Committee   |
| <b>Income Averaging for Commercial Fishermen</b><br>National Taxpayer Advocate 2001 Annual Report to Congress 226.  | Amend IRC § 1301(a) to provide commercial fishermen the benefit of income averaging currently available to farmers.  |   |             |  |
| Legislative Activity 108th Congress   | <b>Pub. L. No. 108-357, § 314, 118 Stat. 1468, 1469 (2004).</b>  |   |             |  |
| <b>Election to be treated as an S Corporation</b><br>National Taxpayer Advocate 2004 Annual Report to Congress 390-393.   | Amend IRC § 1362(a) to allow a small business corporation to elect to be treated as an S corporation no later than the date it timely files (including extensions) its first Form 1120S, <i>U.S. Income Tax Return for an S Corporation</i> .  |   |             |  |
| Legislative Activity 109th Congress   | <b>Bill Number</b>   | <b>Sponsor</b>  | <b>Date</b> | <b>Status</b>  |
|   | HR 3629  | Doggett   | 7/29/2005   | Referred to the Ways & Means Committee   |
| Legislative Activity 109th Congress   | HR 3841  | Manzullo  | 9/2/2005    | Referred to the Ways & Means Committee   |
|   | <b>Regulation of Payroll Tax Deposits Agents</b><br>National Taxpayer Advocate 2004 Annual Report to Congress 394-399.   | Require payroll services to meet certain qualifications to protect businesses that use payroll service providers from tax deposit fund misappropriation or fraud. |             |  |
| Legislative Activity 110th Congress   | <b>Bill Number</b>   | <b>Sponsor</b>  | <b>Date</b> | <b>Status</b>  |
|   | S 1773   | Snowe   | 7/12/2007   | Referred to the Finance Committee  |
| Legislative Activity 109th Congress   | S 3583   | Snowe   | 6/27/2006   | Referred to the Finance Committee  |
|   | S 1321   | Santorum  | 6/28/2005   | 9/15/2006–The Finance Committee. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title; with written report No. 109-336<br>9/15/2006–Placed on the Senate Legislative Calendar under General Orders; Calendar No. 614 |
| <b>Simplification</b>   |  |   |             |  |
| <b>Reduce the Number of Tax Preferences</b><br>National Taxpayer Advocate 2010 Annual Report to Congress 365-372.   | Simplify the complexity of the tax code generally by reducing the number of tax preferences.   |   |             |  |
| Legislative Activity 112th Congress   | <b>Bill Number</b>   | <b>Sponsor</b>  | <b>Date</b> | <b>Status</b>  |
|   | S 727  | Wyden   | 4/5/2011    | Referred to the Finance Committee  |
| <b>Simplify and Streamline Education Tax Incentives</b><br>National Taxpayer Advocate 2008 Annual Report to Congress 370-372<br>National Taxpayer Advocate 2004 Annual Report to Congress 403-422 | Enact reforms to simplify and streamline the education tax incentives by consolidating, creating uniformity among, or adding permanency to the various education tax incentives. Specifically, (1) incentives under § 25A should be consolidated with § 222 and possibly § 221, (2) the education provisions should be made more consistent regarding the relationship of the student to the taxpayer, (3) the definitions for “Qualified Higher Education Expenses” and “Eligible Education Institution” should be simplified, (4) the income level and phase-out calculations should be more consistent under the various provisions, (5) all dollar amounts should be indexed for inflation, and (6) after initial use of sunset provisions and simplification amendments, the incentives should be made permanent. |   |             |  |
| Legislative Activity 112th Congress   | <b>Bill Number</b>   | <b>Sponsor</b>  | <b>Date</b> | <b>Status</b>  |
|   | S 727  | Wyden   | 4/5/2011    | Referred to the Finance Committee  |

## National Taxpayer Advocate Legislative Recommendations with Congressional Action

|  |  |   |                |             |  |
|--|--|---|----------------|-------------|--|
| <b>Simplify and Streamline Retirement Savings Tax Incentives</b>   |  |   |                |             |  |
| National Taxpayer Advocate 2008 Annual Report to Congress 373-374<br>National Taxpayer Advocate 2004 Annual Report to Congress 423-432 |  | Consolidate existing retirement incentives, particularly where the differences in plan attributes are minor. For instance, Congress should consider establishing one retirement plan for individual taxpayers, one for plans offered by small businesses, and one suitable for large businesses and governmental entities (eliminating plans that are limited to governmental entities). At a minimum, Congress should establish uniform rules regarding hardship withdrawals, plan loans, and portability. |                |             |  |
|  |  | <b>Bill Number</b>  | <b>Sponsor</b> | <b>Date</b> | <b>Status</b>  |
| Legislative Activity 112th Congress  |  | S 727   | Wyden          | 4/5/2011    | Referred to the Finance Committee  |
| <b>Tax Gap Provisions</b>  |  |   |                |             |  |
| <b>Corporate Information Reporting</b>   |  |   |                |             |  |
| National Taxpayer Advocate 2008 Annual Report to Congress 388.   |  | Require businesses that pay \$600 or more during the year to non-corporate and corporate service providers to file an information report with each provider and with the IRS. Information reporting already is required on payments for services to non-corporate providers. This applies to payments made after December 31, 2011.   |                |             |  |
|  |  | <b>Bill Number</b>  | <b>Sponsor</b> | <b>Date</b> | <b>Status</b>  |
| Legislative Activity 111th Congress  |  | S 1796  | Baucus         | 10/19/2009  | 10/19/2009 Placed on Senate Legislative Calendar under General Orders. Calendar No. 184  |
| <b>Reporting on Customer's Basis in Security Transaction</b>   |  |   |                |             |  |
| National Taxpayer Advocate 2005 Annual Report to Congress 433-441.   |  | Require brokers to keep track of an investor's basis, transfer basis information to a successor broker if the investor transfers the stock or mutual fund holding, and report basis information to the taxpayer and the IRS (along with the proceeds generated by a sale) on Form 1099-B.   |                |             |  |
| Legislative Activity 110th Congress  |  | <b>Pub. L. No. 110-343, § 403, 121 Stat. 3854, 3855 (2008).</b>   |                |             |  |
|  |  | <b>Bill Number</b>  | <b>Sponsor</b> | <b>Date</b> | <b>Status</b>  |
|  |  | HR 878  | Emanuel        | 2/7/2007    | Referred to the Ways & Means Committee   |
|  |  | S 601   | Bayh           | 2/14/2007   | Referred to the Finance Committee  |
|  |  | S 1111  | Wyden          | 4/16/2007   | Referred to the Finance Committee  |
|  |  | HR 2147   | Emanuel        | 5/3/2007    | Referred to the Ways & Means Committee   |
|  |  | HR 3996 PCS   | Rangel         | 10/30/2007  | 11/14/2007-Placed on the Senate Calendar; became Pub. L. No. 110-166 (2007) without this provision   |
| Legislative Activity 109th Congress  |  | S 2414  | Bayh           | 3/14/2006   | Referred to the Finance Committee  |
|  |  | HR 5176   | Emanuel        | 4/25/2006   | Referred to the Ways & Means Committee   |
|  |  | HR 5367   | Emanuel        | 5/11/2006   | Referred to the Ways & Means Committee   |
| <b>IRS Forms Revisions</b>   |  |   |                |             |  |
| National Taxpayer Advocate 2004 Annual Report to Congress 480.<br>National Taxpayer Advocate 2010 Annual Report to Congress 40.        |  | Revise Form 1040, Schedule C, to include a line item showing the amount of self-employment income that was reported on Forms 1099-MISC.   |                |             |  |
|  |  | <b>Bill Number</b>  | <b>Sponsor</b> | <b>Date</b> | <b>Status</b>  |
| Legislative Activity 112th Congress  |  | S 1289  | Carper         | 6/28/2011   | Referred to the Finance Committee  |
| <b>IRS to Promote Estimated Tax Payments Through the Electronic Federal Tax Payment System (EFTPS)</b>                                 |  |   |                |             |  |
| National Taxpayer Advocate 2005 Annual Report to Congress 381-396.   |  | Amend IRC § 6302(h) to require the IRS to promote estimated tax payments through EFTPS and establish a goal of collecting at least 75 percent of all estimated tax payment dollars through EFTPS by fiscal year 2012.   |                |             |  |
|  |  | <b>Bill Number</b>  | <b>Sponsor</b> | <b>Date</b> | <b>Status</b>  |
| Legislative Activity 109th Congress  |  | S 1321RS  | Santorum       | 6/28/2005   | 9/15/2006-The Finance Committee. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title; with written report No. 109-336<br>9/15/2006-Placed on the Senate Legislative Calendar under General Orders; Calendar No. 614 |

## National Taxpayer Advocate Legislative Recommendations with Congressional Action

|   |   |                |             |  |
|---|---|----------------|-------------|--|
| <p><b>Study of Use of Voluntary Withholding Agreements</b></p> <p>National Taxpayer Advocate 2004 Annual Report to Congress 478-489; National Taxpayer Advocate 2005 Annual Report to Congress 381-396.</p> | <p>Amend IRC § 3402(p)(3) to specifically authorize voluntary withholdings agreements between independent contractors and service-recipients as defined in IRC § 6041A(a)(1).</p>   |                |             |  |
| <p>Legislative Activity 109th Congress</p>  | S 1321RS  | Santorum       | 6/28/2005   | <p>9/15/2006-The Finance Committee. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title; with written report No. 109-336.</p> <p>9/15/2006-Placed on the Senate Legislative Calendar under General Orders; Calendar No. 614</p> |
| <p><b>Require Form 1099 Reporting for Incorporated Service Providers</b></p> <p>National Taxpayer Advocate 2007 Report to Congress 494-496.</p>   | <p>Require service recipients to issue Forms 1099-MISC to incorporated service providers and increase the penalties for failure to comply with the information reporting requirements.</p>  |                |             |  |
| <p>Legislative Activity 111th Congress</p>  | <p><b>Pub. L No. 111-148 § 9006 (2010).</b></p> <p>However, this Act also contains a reporting requirement for goods sold, which the National Taxpayer Advocate opposes because of the enormous burden it places on businesses. See Legislative Recommendation: Repeal the Information Reporting Requirement for Purchases of Goods over \$600, but Require Reporting on Corporate and Certain Other Payments, infra.</p>                           |                |             |  |
| <p><b>Require Financial Institutions to Report All Accounts to the IRS by Eliminating the \$10 Threshold on Interest Reporting</b></p> <p>National Taxpayer Advocate 2007 Report to Congress 501-502.</p>   | <p>Eliminate the \$10 interest threshold beneath which financial institutions are not required to file Form 1099-INT reports with the IRS.</p>  |                |             |  |
|   | <b>Bill Number</b>  | <b>Sponsor</b> | <b>Date</b> | <b>Status</b>  |
| <p>Legislative Activity 112th Congress</p>  | S 1289  | Carper         | 6/28/2011   | Referred to the Finance Committee  |
| <p>Legislative Activity 111th Congress</p>  | S 3795  | Carper         | 9/16/2010   | Referred to the Finance Committee  |
| <p><b>Revise Form 1040, Schedule C to break out gross receipts reported on payee statements such as Form 1099</b></p> <p>National Taxpayer Advocate 2007 Report to Congress 40.</p>                         | <p>Administrative recommendation that the IRS add a line to Schedule C so that taxpayers would separately report the amount of income reported to them on Forms 1099 and other income not reported on Forms 1099. If enacted by statute, the IRS would be required to implement this recommendation.</p>  |                |             |  |
|   | <b>Bill Number</b>  | <b>Sponsor</b> | <b>Date</b> | <b>Status</b>  |
| <p>Legislative Activity 111th Congress</p>  | S 3795  | Carper         | 9/16/2010   | Referred to the Finance Committee  |
| <p><b>Include a Checkbox on Business Returns Requiring Taxpayers to Verify that they Filed all Required Forms 1099</b></p> <p>National Taxpayer Advocate 2007 Report to Congress 40.</p>                    | <p>Administrative recommendation that the IRS require all businesses to answer two questions on their income tax returns: "Did you make any payments over \$600 in the aggregate during the year to any unincorporated trade or business?" and "If yes, did you file all required Forms 1099?" S 3795 would require the IRS to study whether placing a checkbox or similar indicator on business tax returns would affect voluntary compliance.</p> |                |             |  |
|   | <b>Bill Number</b>  | <b>Sponsor</b> | <b>Date</b> | <b>Status</b>  |
| <p>Legislative Activity 111th Congress</p>  | S 3795  | Carper         | 9/16/2010   | Referred to the Finance Committee  |
| <p><b>Authorize Voluntary Withholding Upon Request</b></p> <p>National Taxpayer Advocate 2007 Report to Congress 493-494.</p>   | <p>Authorize voluntary withholding agreements between independent contractors and service recipients.</p>   |                |             |  |
|   | <b>Bill Number</b>  | <b>Sponsor</b> | <b>Date</b> | <b>Status</b>  |
| <p>Legislative Activity 111th Congress</p>  | S 3795  | Carper         | 9/16/2010   | Referred to the Finance Committee  |

## National Taxpayer Advocate Legislative Recommendations with Congressional Action

|  |   |                |             |  |
|--|---|----------------|-------------|--|
| <b>Require Backup Withholding on Certain Payments When TINs Cannot Be Validated</b><br>National Taxpayer Advocate 2005 Report to Congress 238-248. | Administrative recommendation that the IRS require payors to commence backup withholding if they do not receive verification of a payee's TIN. (S. 3795 would require voluntary withholding on certain payments.)   |                |             |  |
|  | <b>Bill Number</b>  | <b>Sponsor</b> | <b>Date</b> | <b>Status</b>                          |
| Legislative Activity 111th Congress  | S 3795  | Carper         | 9/16/2010   | Referred to the Finance Committee      |
| <b>Worker Classification</b><br>National Taxpayer Advocate 2008 Annual Report to Congress 375-390.   | Direct Treasury and the Joint Committee on Taxation to report on the operation of the revised worker classification rules and provide recommendations to increase compliance.   |                |             |  |
|  | <b>Bill Number</b>  | <b>Sponsor</b> | <b>Date</b> | <b>Status</b>                          |
| Legislative Activity 112th Congress  | S 1289  | Carper         | 6/28/2011   | Referred to the Finance Committee      |
| <b>Taxpayer Bill of Rights and <i>De Minimis</i> "Apology" Payments</b>  |   |                |             |  |
| <b>Taxpayer Bill of Rights</b><br>National Taxpayer Advocate 2007 Report to Congress 486-489.  | Enact a Taxpayer Bill of Rights setting forth the fundamental rights and obligations of U.S. taxpayers.   |                |             |  |
|  | <b>Bill Number</b>  | <b>Sponsor</b> | <b>Date</b> | <b>Status</b>                          |
| Legislative Activity 111th Congress  | S 3215  | Bingaman       | 4/15/2010   | Referred to the Ways & Means Committee |
|  | HR 5047   | Becerra        | 4/15/2010   | Referred to the Finance Committee      |
| Legislative Activity 110th Congress  | HR 5716   | Becerra        | 4/8/2008    | Referred to the Ways & Means Committee |
| <b><i>De Minimis</i> "Apology" Payments</b><br>National Taxpayer Advocate 2007 Report to Congress 490.   | Grant the National Taxpayer Advocate the discretionary, nondelegable authority to provide <i>de minimis</i> compensation to taxpayers where the action or inaction of the IRS has caused excessive expense or undue burden to the taxpayer and the taxpayer meets the IRC § 7811 definition of significant hardship.  |                |             |  |
|  | <b>Bill Number</b>  | <b>Sponsor</b> | <b>Date</b> | <b>Status</b>                          |
| Legislative Activity 112th Congress  | S 1289  | Carper         | 6/28/2011   | Referred to the Finance Committee      |
| Legislative Activity 111th Congress  | S 3795  | Carper         | 9/16/2010   | Referred to the Finance Committee      |
| <b>Simplify the Tax Treatment of Cancellation of Debt Income</b>   |   |                |             |  |
| <b>Simplify the Tax Treatment of Cancellation of Debt Income</b><br>National Taxpayer Advocate 2008 Report to Congress 391-396.                    | Enact one of several proposed alternatives to remove taxpayers with modest amounts of debt cancellation from the cancellation of debt income regime.  |                |             |  |
|  | <b>Bill Number</b>  | <b>Sponsor</b> | <b>Date</b> | <b>Status</b>                          |
| Legislative Activity 111th Congress  | HR 4561   | Lewis          | 2/2/2010    | Referred to the Ways & Means Committee |
| <b>Joint and Several Liability</b>   |   |                |             |  |
| <b>Tax Court Review of Request for Equitable Innocent Spouse Relief</b><br>National Taxpayer Advocate 2001 Annual Report to Congress 128-165.      | Amend IRC § 6015(e) to clarify that taxpayers have the right to petition the Tax Court to challenge determinations in cases seeking relief under IRC § 6015(f) alone.   |                |             |  |
| Legislative Activity 109th Congress  | <b>Pub. L. No. 109-432, § 408, 120 Stat. 3061, 3062 (2006).</b>   |                |             |  |
| <b>Collection Issues</b>   |   |                |             |  |
| <b>Improve Offer In Compromise Program Accessibility</b><br>National Taxpayer Advocate 2006 Annual Report to Congress 507-519.                     | Repeal the partial payment requirement, or if repeal is not possible, (1) provide taxpayers with the right to appeal to the IRS Appeals function the IRS's decision to return an offer without considering it on the merits; (2) reduce the partial payment to 20 percent of current income and liquid assets that could be disposed of immediately without significant cost; and (3) create an economic hardship exception to the requirement. |                |             |  |

## National Taxpayer Advocate Legislative Recommendations with Congressional Action

|  | Bill Number  | Sponsor  | Date       | Status   |
|--|--|----------|------------|--|
| Legislative Activity 112th Congress  | S 1289   | Carper   | 6/28/2011  | Referred to the Finance Committee  |
| Legislative Activity 111th Congress  | HR 4994  | Lewis    | 4/13/2010  | Referred to the Ways & Means Committee   |
|  | HR 2342  | Lewis    | 5/12/2009  | Referred to the Ways & Means Committee   |
| <b>Strengthen Taxpayer Protections in the Filing and Reporting of Federal Tax Liens</b><br>2009 National Taxpayer Advocate Report to Congress 357-364. | Provide clear and specific guidance about the factors the IRS must consider when filing a Notice of Federal Tax Lien (NFL) and amend the Fair Credit Reporting Act to set specific timeframes for reporting derogatory tax lien information on credit reports.   |          |            |  |
|  | Bill Number  | Sponsor  | Date       | Status   |
| Legislative Activity 111th Congress  | S 3215   | Bingaman | 4/15/2010  | Referred to the Finance Committee  |
|  | HR 5047  | Becerra  | 4/15/2010  | Referred to the Ways & Means Committee   |
|  | HR 6439  | Hastings | 11/18/2010 | Referred to the Ways & Means Committee   |
| <b>Return of Levy or Sale Proceeds</b><br>National Taxpayer Advocate 2001 Annual Report to Congress 202-214.   | Amend IRC § 6343(b) to extend the period of time within which a third party can request a return of levied funds or the proceeds from the sale of levied property from nine months to two years from the date of levy. This amendment would also extend the period of time available to taxpayers under IRC § 6343(d) within which to request a return of levied funds or sale proceeds.   |          |            |  |
|  | Bill Number  | Sponsor  | Date       | Status   |
| Legislative Activity 110th Congress  | HR 5719  | Rangel   | 4/16/2008  | Referred to the Finance Committee  |
|  | HR 1677  | Rangel   | 3/26/2007  | Referred to the Finance Committee  |
| Legislative Activity 109th Congress  | S 1321 RS  | Santorum | 6/28/2005  | 9/15/2006-The Finance Committee. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336<br>9/15/2006-Placed on the Senate Legislative Calendar under General Orders. Calendar No. 614 |
| Legislative Activity 108th Congress  | HR 1528  | Portman  | 6/20/2003  | 5/19/2004-Passed/agreed to in the Senate, with an amendment  |
|  | HR 1661  | Rangel   | 4/8/2003   | Referred to the Ways & Means Committee   |
| Legislative Activity 107th Congress  | HR 3991  | Houghton | 3/19/2002  | Defeated in House  |
|  | HR 586   | Lewis    | 2/13/2001  | 4/18/02-Passed the House with an amendment; referred to the Senate   |
| <b>Reinstatement of Retirement Accounts</b><br>National Taxpayer Advocate 2001 Annual Report to Congress 202-214.                                      | Amend the following IRC sections to allow contributions to individual retirement accounts and other qualified plans from the funds returned to the taxpayer or to third parties under IRC § 6343: <ul style="list-style-type: none"> <li>◆ § 401 - Qualified Pension, Profit Sharing, Keogh, and Stock Bonus Plans</li> <li>◆ § 408 - Individual Retirement Account, and SEP-Individual Retirement Account</li> <li>◆ § 408A - Roth Individual Retirement Account</li> </ul> |          |            |  |
|  | Bill Number  | Sponsor  | Date       | Status   |
| Legislative Activity 110th Congress  | HR 5719  | Rangel   | 4/16/2008  | Referred to the Finance Committee  |
|  | HR 1677  | Rangel   | 3/26/2007  | Referred to the Finance Committee  |
| Legislative Activity 109th Congress  | S 1321RS   | Santorum | 6/28/2005  | 9/15/2006-The Finance Committee. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title with written report No. 109-336<br>9/15/2006-Placed on the Senate Legislative Calendar under General Orders. Calendar No. 614  |

## National Taxpayer Advocate Legislative Recommendations with Congressional Action

|  |   |                |             |  |
|--|---|----------------|-------------|--|
| Legislative Activity 108th Congress  | HR 1528   | Portman        | 6/20/2003   | 5/19/2004–Passed/agreed to in the Senate, with an amendment  |
|  | HR 1661   | Rangel         | 4/8/2003    | Referred to the Ways & Means Committee   |
|  | S 882   | Baucus         | 4/10/2003   | 5/19/2004–S 882 was incorporated in H.R. 1528 through an amendment and HR 1528 passed in lieu of S 882 |
| Legislative Activity 107th Congress  | HR 586  | Lewis          | 2/13/2001   | 4/18/2002–Passed the House with an amendment; referred to Senate                                       |
|  | HR 3991   | Houghton       | 3/19/2002   | Defeated in the House  |
| <b>Consolidation of Appeals of Collection Due Process (CDP) Determinations</b><br>National Taxpayer Advocate 2004 Annual Report to Congress 451-470. | Consolidate judicial review of CDP hearings in the United States Tax Court, clarify the role and scope of Tax Court oversight of Appeals' continuing jurisdiction over CDP cases, and address the Tax Court's standard of review for the underlying liability in CDP cases.   |                |             |  |
| Legislative Activity 109th Congress  | <b>Pub. L. No. 109-280, § 855, 120 Stat. 1019 (2006).</b>   |                |             |  |
| <b>Partial Payment Installment Agreements</b><br>National Taxpayer Advocate 2001 Annual Report to Congress 210-214.                                  | Amend IRC § 6159 to allow the IRS to enter into installment agreements that do not provide for full payment of the tax liability over the statutory limitations period for collection of tax where it appears to be in the best interests of the taxpayer and the IRS.  |                |             |  |
| Legislative Activity 108th Congress  | <b>Pub. L. No. 108-357, § 833, 118 Stat. 1589-1592 (2004).</b>  |                |             |  |
| <b>Penalties and Interest</b>  |   |                |             |  |
| <b>Interest Rate and Failure to Pay Penalty</b><br>National Taxpayer Advocate 2001 Annual Report to Congress 179-182.                                | Repeal the failure to pay penalty provisions of IRC § 6651 while revising IRC § 6621 to allow for a higher underpayment interest rate.  |                |             |  |
| Legislative Activity 108th Congress  | <b>Bill Number</b>  | <b>Sponsor</b> | <b>Date</b> | <b>Status</b>  |
|  | HR 1528   | Portman        | 6/20/2003   | 5/19/2004–Passed/agreed to in the Senate, with an amendment  |
|  | HR 1661   | Rangel         | 4/8/2003    | Referred to the Ways & Means Committee   |
| <b>Interest Abatement on Erroneous Refunds</b><br>National Taxpayer Advocate 2001 Annual Report to Congress 183-187.                                 | Amend IRC § 6404(e)(2) to require the Secretary to abate the assessment of all interest on any erroneous refund under IRC § 6602 until the date the demand for repayment is made, unless the taxpayer (or a related party) has in any way caused such an erroneous refund. Further, the Secretary should have discretion not to abate any or all such interest where the Secretary can establish that the taxpayer had notice of the erroneous refund before the date of demand and the taxpayer did not attempt to resolve the issue with the IRS within 30 days of such notice. |                |             |  |
| Legislative Activity 109th Congress  | <b>Bill Number</b>  | <b>Sponsor</b> | <b>Date</b> | <b>Status</b>  |
|  | HR 726  | Sanchez        | 2/9/2005    | Referred to the Ways & Means Committee   |
| Legislative Activity 108th Congress  | HR 1528   | Portman        | 6/20/2003   | 5/19/2004–Passed/agreed to in the Senate, with an amendment  |
|  | HR 1661   | Rangel         | 4/8/2003    | Referred to the Ways & Means Committee   |
| <b>First Time Penalty Waiver</b><br>National Taxpayer Advocate 2001 Annual Report to Congress 188-192.   | Authorize the IRS to provide penalty relief for first-time filers and taxpayers with excellent compliance histories who make reasonable attempts to comply with the tax rules.  |                |             |  |
| Legislative Activity 108th Congress  | <b>Bill Number</b>  | <b>Sponsor</b> | <b>Date</b> | <b>Status</b>  |
|  | HR 1528   | Portman        | 6/20/2003   | 5/19/2004–Passed/agreed to in the Senate, with an amendment  |
|  | HR 1661   | Rangel         | 4/8/2003    | Referred to the Ways & Means Committee   |
| Legislative Activity 107th Congress  | HR 3991   | Houghton       | 3/19/2002   | Defeated in the House  |

## National Taxpayer Advocate Legislative Recommendations with Congressional Action

|  |  |                |             |  |
|--|--|----------------|-------------|--|
| <b>Federal Tax Deposit (FTD) Avoidance Penalty</b><br>National Taxpayer Advocate 2001 Annual Report to Congress 222.             | Reduce the maximum FTD penalty rate from ten to two percent for taxpayers who make deposits on time but not in the manner prescribed in the IRC.   |                |             |  |
| Legislative Activity 109th Congress  | <b>Bill Number</b>   | <b>Sponsor</b> | <b>Date</b> | <b>Status</b>  |
|  | HR 3629  | Doggett        | 7/29/2005   | Referred to the Ways & Means Committee   |
|  | HR 3841  | Manzullo       | 9/2//2005   | Referred to the Ways & Means Committee   |
| Legislative Activity 108th Congress  | S 1321RS   | Santorum       | 6/28/2005   | 9/15/2006-The Finance Committee. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title; with written report No. 109-336<br>9/15/2006-Placed on the Senate Legislative Calendar under General Orders; Calendar No. 614 |
|  | <b>Bill Number</b>   | <b>Sponsor</b> | <b>Date</b> | <b>Status</b>  |
|  | HR 1528  | Portman        | 6/20/2003   | 5/19/2004-Passed/agreed to in the Senate, with an amendment  |
| Legislative Activity 107th Congress  | HR 1661  | Rangel         | 4/8/2003    | Referred to the Ways & Means Committee   |
|  | HR 586   | Lewis          | 2/13/2001   | 4/18/2002-Passed the House with an amendment; referred to the Senate   |
|  | HR 3991  | Houghton       | 3/19/2002   | Defeated in the House  |
| <b>Family Issues</b>   |  |                |             |  |
| <b>Uniform Definition of a Qualifying Child</b><br>National Taxpayer Advocate 2001 Annual Report to Congress 78-100.             | Create a uniform definition of "qualifying child" applicable to tax provisions relating to children and family status.   |                |             |  |
| Legislative Activity 108th Congress  | <b>Pub. L. No. 108-311, § 201, 118 Stat. 1169-1175 (2004).</b>   |                |             |  |
| <b>Means Tested Public Assistance Benefits</b><br>National Taxpayer Advocate 2001 Annual Report to Congress 76-127.              | Amend the IRC §§ 152, 2(b) and 7703(b) to provide that means-tested public benefits are excluded from the computation of support in determining whether a taxpayer is entitled to claim the dependency exemption and from the cost of maintenance test for the purpose of head-of-household filing status or "not married" status. |                |             |  |
| Legislative Activity 108th Congress  | <b>Bill Number</b>   | <b>Sponsor</b> | <b>Date</b> | <b>Status</b>  |
|  | HR 22  | Houghton       | 1/3/2003    | Referred to the Ways & Means Committee   |
| <b>Credits for the Elderly or the Permanently Disabled</b><br>National Taxpayer Advocate 2001 Annual Report to Congress 218-219. | Amend IRC § 22 to adjust the income threshold amount for past inflation and provide for future indexing for inflation.   |                |             |  |
| Legislative Activity 107th Congress  | <b>Bill Number</b>   | <b>Sponsor</b> | <b>Date</b> | <b>Status</b>  |
|  | S 2131   | Bingaman       | 4/15/2002   | Referred to the Finance Committee  |
| <b>Electronic Filing Issues</b>  |  |                |             |  |
| <b>Direct Filing Portal</b><br>National Taxpayer Advocate 2004 Annual Report to Congress 471-477.                                | Amend IRC § 6011(f) to require the IRS to post fill-in forms on its website and make electronic filing free to all individual taxpayers.   |                |             |  |
| Legislative Activity 112th Congress  | <b>Bill Number</b>   | <b>Sponsor</b> | <b>Date</b> | <b>Status</b>  |
|  | S 1289   | Carper         | 6/28/2011   | Referred to the Finance Committee  |
| Legislative Activity 110th Congress  | S 1074   | Akaka          | 3/29/2007   | Referred to the Finance Committee  |
|  | HR 5801  | Lampson        | 4/15/2008   | Referred to the Ways & Means Committee   |

National Taxpayer Advocate Legislative Recommendations with Congressional Action

|   |   |                |             |  |
|---|---|----------------|-------------|--|
| Legislative Activity 109th Congress   | S 1321RS  | Santorum       | 6/28/2005   | 9/15/2006-Referred to the Finance Committee; Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title; with written report No. 109-336<br>9/15/2006-Placed on the Senate Legislative Calendar under General Orders; Calendar No. 614 |
| <b>Free Electronic Filing For All Taxpayers</b>                                       |   |                |             |  |
| National Taxpayer Advocate 2004 Annual Report to Congress 471-477.                    | Revise IRC § 6011(f) to provide that the Secretary shall make electronic return preparation and electronic filing available without charge to all individual taxpayers.   |                |             |  |
|   | <b>Bill Number</b>  | <b>Sponsor</b> | <b>Date</b> | <b>Status</b>  |
| Legislative Activity 110th Congress   | S 2861  | Schumer        | 4/15/2008   | Referred to the Finance Committee  |
| <b>Office of the Taxpayer Advocate</b>  |   |                |             |  |
| <b>Confidentiality of Taxpayer Communications</b>                                     |   |                |             |  |
| National Taxpayer Advocate 2002 Annual Report to Congress 198-215.                    | Strengthen the independence of the National Taxpayer Advocate and the Office of the Taxpayer Advocate by amending IRC §§ 7803(c)(3) and 7811. Amend IRC § 7803(c)(4)(A)(iv) to clarify that, notwithstanding any other provision of the IRC, Local Taxpayer Advocates have the discretion to withhold from the IRS the fact that a taxpayer contacted the Taxpayer Advocate Service or any information provided by a taxpayer to TAS. |                |             |  |
|   | <b>Bill Number</b>  | <b>Sponsor</b> | <b>Date</b> | <b>Status</b>  |
| Legislative Activity 108th Congress   | HR 1528   | Portman        | 6/20/2003   | 5/19/2004-Passed/agreed to in the Senate, with an amendment  |
|   | HR 1661   | Rangel         | 4/8/2003    | Referred to the Ways & Means Committee   |
| <b>Access to Independent Legal Counsel</b>  |   |                |             |  |
| National Taxpayer Advocate 2002 Annual Report to Congress 198-215.                    | Amend IRC § 7803(c)(3) to provide for the position of Counsel to the National Taxpayer Advocate, who shall advise the National Taxpayer Advocate on matters pertaining to taxpayer rights, tax administration, and the Office of Taxpayer Advocate, including commenting on rules, regulations, and significant procedures, and the preparation of <i>amicus</i> briefs.  |                |             |  |
|   | <b>Bill Number</b>  | <b>Sponsor</b> | <b>Date</b> | <b>Status</b>  |
| Legislative Activity 108th Congress   | HR 1528   | Portman        | 6/20/2003   | Referred to the Senate   |
|   | HR 1661   | Rangel         | 4/8/2003    | Referred to the Ways & Means Committee   |
| <b>Taxpayer Advocate Directive</b>  |   |                |             |  |
| National Taxpayer Advocate 2002 Report to Congress 419-422.                           | Amended IRC § 7811 to provide the National Taxpayer Advocate with the non-delegable authority to issue a Taxpayer Advocate Directive to the Internal Revenue Service with respect to any program, proposed program, action, or failure to act that may create a significant hardship for a taxpayer segment or taxpayers at large.  |                |             |  |
|   | <b>Bill Number</b>  | <b>Sponsor</b> | <b>Date</b> | <b>Status</b>  |
| Legislative Activity 111th Congress   | S 3215  | Bingaman       | 4/15/2010   | Referred to the Finance Committee  |
|   | HR 5047   | Becerra        | 4/15/2010   | Referred to the Ways & Means Committee   |
| <b>Other Issues</b>   |   |                |             |  |
| <b>Modify Internal Revenue Code Section 6707A to Ameliorate Unconscionable Impact</b> |   |                |             |  |
| National Taxpayer Advocate 2008 Annual Report to Congress 419-422.                    | Modify IRC § 6707A to ameliorate unconscionable impact. Section 6707A of the IRC imposes a penalty of \$100,000 per individual per year and \$200,000 per entity per year for failure to make special disclosures of a "listed transaction."  |                |             |  |
| Legislative Activity 111th Congress   | <b>Pub. L. No. 111-124, § 2041 Stat. 2560 (2010).</b>   |                |             |  |
|   | <b>Bill Number</b>  | <b>Sponsor</b> | <b>Date</b> | <b>Status</b>  |
|   | S 2771  | Baucus         | 11/16/2009  | Referred to the Finance Committee  |
|   | HR 4068   | Lewis          | 11/16/2009  | Referred to the Ways & Means Committee   |
|   | S 2917  | Baucus         | 12/18/2009  | Referred to the Finance Committee  |

Legislative Recommendations

## National Taxpayer Advocate Legislative Recommendations with Congressional Action

| <p><b>Eliminate Tax Strategy Patents</b><br/>National Taxpayer Advocate 2007 Annual Report to Congress 512-524.</p>    | <p>Bar tax strategy patents, which increase compliance costs and undermine respect for congressionally-created incentives, or require the PTO to send any tax strategy patent applications to the IRS so that abuse can be mitigated.</p>  |             |  |           |                                   |         |         |           |   |       |        |           |  |         |        |          |  |
|--|--|-------------|--|-----------|-----------------------------------|---------|---------|-----------|---|-------|--------|-----------|--|---------|--------|----------|--|
| <p>Legislative Activity 112th Congress</p>   | <p><b>Pub. L. No. 112-29 § 14(a), 125 Stat. 284, 327 (2011).</b></p>   |             |  |           |                                   |         |         |           |   |       |        |           |  |         |        |          |  |
| <p><b>Disclosure Regarding Suicide Threats</b><br/>National Taxpayer Advocate 2001 Annual Report to Congress 227.</p>  | <p>Amend IRC § 6103(i)(3)(B) to allow the IRS to contact and provide necessary return information to specified local law enforcement agencies and local suicide prevention authorities, in addition to federal and state law enforcement agencies in situations involving danger of death or physical injury.</p>  |             |  |           |                                   |         |         |           |   |       |        |           |  |         |        |          |  |
| <p>Legislative Activity 112th Congress</p>   | <table border="1"> <thead> <tr> <th>Bill Number</th> <th>Sponsor</th> <th>Date</th> <th>Status</th> </tr> </thead> <tbody> <tr> <td>HR 1528</td> <td>Portman</td> <td>6/20/2003</td> <td>5/19/2004—Passed/agreed to in the Senate, with an amendment</td> </tr> <tr> <td>S 882</td> <td>Baucus</td> <td>4/10/2003</td> <td>5/19/2004—S 882 was incorporated in HR 1528 through an amendment and HR 1528 passed in lieu of S 882</td> </tr> <tr> <td>HR 1661</td> <td>Rangel</td> <td>4/8/2003</td> <td>Referred to the Ways &amp; Means Committee</td> </tr> </tbody> </table> | Bill Number | Sponsor  | Date      | Status                            | HR 1528 | Portman | 6/20/2003 | 5/19/2004—Passed/agreed to in the Senate, with an amendment     | S 882 | Baucus | 4/10/2003 | 5/19/2004—S 882 was incorporated in HR 1528 through an amendment and HR 1528 passed in lieu of S 882 | HR 1661 | Rangel | 4/8/2003 | Referred to the Ways & Means Committee |
| Bill Number  | Sponsor  | Date        | Status   |           |                                   |         |         |           |   |       |        |           |  |         |        |          |  |
| HR 1528  | Portman  | 6/20/2003   | 5/19/2004—Passed/agreed to in the Senate, with an amendment  |           |                                   |         |         |           |   |       |        |           |  |         |        |          |  |
| S 882  | Baucus   | 4/10/2003   | 5/19/2004—S 882 was incorporated in HR 1528 through an amendment and HR 1528 passed in lieu of S 882 |           |                                   |         |         |           |   |       |        |           |  |         |        |          |  |
| HR 1661  | Rangel   | 4/8/2003    | Referred to the Ways & Means Committee   |           |                                   |         |         |           |   |       |        |           |  |         |        |          |  |
| <p><b>Attorney Fees</b><br/>National Taxpayer Advocate 2002 Annual Report to Congress 161-171.</p>                     | <p>Allow successful plaintiffs in nonphysical personal injury cases who must include legal fees in gross income to deduct the fees “above the line.” Thus, the net tax effect would not vary depending on the state in which a plaintiff resides.</p>  |             |  |           |                                   |         |         |           |   |       |        |           |  |         |        |          |  |
| <p>Legislative Activity 108th Congress</p>   | <p><b>Pub. L. No. 108-357, § 703, 118 Stat. 1546-1548 (2004).</b></p>  |             |  |           |                                   |         |         |           |   |       |        |           |  |         |        |          |  |
| <p><b>Attainment of Age Definition</b><br/>National Taxpayer Advocate 2003 Annual Report to Congress 308-311.</p>      | <p>Amend IRC § 7701 by adding a new subsection as follows: “Attainment of Age. An individual attains the next age on the anniversary of his date of birth.”</p>  |             |  |           |                                   |         |         |           |   |       |        |           |  |         |        |          |  |
| <p>Legislative Activity 108th Congress</p>   | <table border="1"> <thead> <tr> <th>Bill Number</th> <th>Sponsor</th> <th>Date</th> <th>Status</th> </tr> </thead> <tbody> <tr> <td>HR 4841</td> <td>Burns</td> <td>7/15/2004</td> <td>7/21/2004—Passed the House;<br/>7/22/2004—Received in the Senate</td> </tr> </tbody> </table>   | Bill Number | Sponsor  | Date      | Status                            | HR 4841 | Burns   | 7/15/2004 | 7/21/2004—Passed the House;<br>7/22/2004—Received in the Senate |       |        |           |  |         |        |          |  |
| Bill Number  | Sponsor  | Date        | Status   |           |                                   |         |         |           |   |       |        |           |  |         |        |          |  |
| HR 4841  | Burns  | 7/15/2004   | 7/21/2004—Passed the House;<br>7/22/2004—Received in the Senate                                      |           |                                   |         |         |           |   |       |        |           |  |         |        |          |  |
| <p><b>Home-Based Service Workers (HBSW)</b><br/>National Taxpayer Advocate 2001 Annual Report to Congress 193-201.</p> | <p>Amend IRC § 3121(d) to clarify that HBSWs are employees rather than independent contractors.</p>  |             |  |           |                                   |         |         |           |   |       |        |           |  |         |        |          |  |
| <p>Legislative Activity 110th Congress</p>   | <table border="1"> <thead> <tr> <th>Bill Number</th> <th>Sponsor</th> <th>Date</th> <th>Status</th> </tr> </thead> <tbody> <tr> <td>HR 5719</td> <td>Rangel</td> <td>4/16/2008</td> <td>Referred to the Finance Committee</td> </tr> </tbody> </table>   | Bill Number | Sponsor  | Date      | Status                            | HR 5719 | Rangel  | 4/16/2008 | Referred to the Finance Committee                               |       |        |           |  |         |        |          |  |
| Bill Number  | Sponsor  | Date        | Status   |           |                                   |         |         |           |   |       |        |           |  |         |        |          |  |
| HR 5719  | Rangel   | 4/16/2008   | Referred to the Finance Committee  |           |                                   |         |         |           |   |       |        |           |  |         |        |          |  |
| <p>Legislative Activity 107th Congress</p>   | <table border="1"> <tbody> <tr> <td>S 2129</td> <td>Bingaman</td> <td>4/15/2002</td> <td>Referred to the Finance Committee</td> </tr> </tbody> </table>  | S 2129      | Bingaman   | 4/15/2002 | Referred to the Finance Committee |         |         |           |   |       |        |           |  |         |        |          |  |
| S 2129   | Bingaman   | 4/15/2002   | Referred to the Finance Committee  |           |                                   |         |         |           |   |       |        |           |  |         |        |          |  |

LR  
#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.<sup>1</sup>

In addition to a declining budget, the IRS is faced with a taxpayer base that is increasingly diverse and has differing needs, education levels, income levels, and basic understandings of the tax system.<sup>2</sup> The results of a recent survey of taxpayers regarding their understanding of their rights provide insight into the need for Congress to both enumerate and further protect the rights of taxpayers. When asked if they believed they had rights before the IRS, 55 percent of taxpayers responded “No.”<sup>3</sup> Further, when asked if they knew what their rights were, 61 percent responded “No” or “Not Sure.”<sup>4</sup> As discussed in the Most Serious Problem *Introduction to Diversity Issues: The IRS Should Do More to Accommodate Changing Taxpayer Demographics*, *supra*, differing taxpayer income levels, education levels, and needs underscore the importance of a clear and concise statement of taxpayer rights accessible to all taxpayers.

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).<sup>5</sup> During that time, both the House and the Senate have introduced various bills that incorporate the Taxpayer Bill of Rights (TBOR) proposed by the National Taxpayer Advocate in 2007.<sup>6</sup> However, in that same intervening 13-year period Congress has enacted over 140 new pieces of tax legislation incorporating about 5,000 changes to the tax code.<sup>7</sup>

The current budget situation for the IRS is much like the climate at the time leading up to RRA 98. In a report to the IRS Oversight Board, former IRS Commissioner Charles Rossotti described the economic situation facing the IRS in the years prior to RRA 98: “Budget and staff cuts, rapid economic growth and the shift in the tax base from

<sup>1</sup> See Most Serious Problems: *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*, *supra*, and *The IRS Is Not Adequately Funded to Serve Taxpayers and Collect Taxes*, *supra*, for a discussion of the impact of the dual pressures of budget constraints and expanding responsibilities on taxpayer rights.

<sup>2</sup> See Most Serious Problem *Introduction to Diversity Issues: The IRS Should Do More to Accommodate Changing Taxpayer Demographics*, *supra*.

<sup>3</sup> Forrester Omnibus Mail Survey for the Taxpayer Advocate Service (Nov. 2011).

<sup>4</sup> *Id.*

<sup>5</sup> RRA 98, Pub. L. No. 105-206, 112 Stat. 685 (1998).

<sup>6</sup> See S. 3215, 111th Cong. (2010); H.R. 5047, 111th Cong. (2010); H.R. 5716, 110th Cong. (2008). See also National Taxpayer Advocate 2007 Annual Report to Congress 478-489.

<sup>7</sup> CCH Database, *Acts Supplementing the 1986 Code*, Nov. 16, 2011. Including all legislation enacted through Nov. 16, 2011.

middle-income wage earners and domestic corporations to upper-income entrepreneurs, passthrough entities and global corporations, all contributed to a diminished capacity to cope with service and compliance demands.”<sup>8</sup> These factors and more led to a situation where the IRS attempted to justify a larger budget by focusing on enforcement and revenue raising.<sup>9</sup> With a continuing budget situation similar to this one, Congress should act proactively to protect taxpayers in order to prevent a recurrence of events that brought about RRA 98. In a time when the IRS will feel pressure to bring in additional tax revenue, it is crucial to provide taxpayers with strong protections for their rights.

## RECOMMENDATION

The National Taxpayer Advocate urges Congress to enact the legislative recommendations detailed in previous annual reports, beginning with the 2007 recommendation to codify a taxpayer bill of rights (TBOR) that would explicitly detail the rights and responsibilities of taxpayers.<sup>10</sup> The rights and responsibilities enumerated in the proposed TBOR are:

### *Taxpayer rights:*

- Right to be Informed;
- Right to be Assisted;
- Right to be Heard;
- Right to pay no more than the correct amount of tax;
- Right of Appeal;
- Right to Certainty;
- Right to Privacy;
- Right to Confidentiality;
- Right to Representation; and
- Right to Fair and Just Tax System.

### *Taxpayer responsibilities:*

- Obligation to be honest;
- Obligation to be cooperative;
- Obligation to provide accurate information and documents on time;
- Obligation to keep records; and
- Obligation to pay taxes on time.

<sup>8</sup> Commissioner Charles O. Rossotti, *Report to the IRS Oversight Board: Assessment of the IRS and the Tax System 3* (Sept. 2002).

<sup>9</sup> *Id.*

<sup>10</sup> See National Taxpayer Advocate 2007 Annual Report to Congress 478-489. Legislative activity incorporating this recommendation in whole or in part: S. 3215, 111th Cong. (2010); H.R. 5047, 111th Cong. (2010); H.R. 5716, 110th Cong. (2008).

## EXPLANATION OF RECOMMENDATION

Taxpayers are entitled to all of the rights and are obligated to conform with all of the responsibilities outlined in the proposed TBOR. The TBOR would codify those rights and responsibilities in one place and make it clear to taxpayers what those rights and responsibilities are. In Appendix I, we cross-reference these rights and responsibilities to current laws and regulations.

In making this recommendation, the National Taxpayer Advocate intends that taxpayers will be able to see their rights and responsibilities codified, the principles of which already form a basis for existing laws, regulations, and other sources of authority where those rights and responsibilities are impacted. Additionally, Congress should strengthen the already existing rights by enacting the previously recommended legislative changes detailed below. The National Taxpayer Advocate firmly believes that enacting these additional protections and making it clear to taxpayers what their rights and responsibilities include will enable taxpayers to avail themselves of the protections to which they are entitled and enhance taxpayer compliance. Moreover, a codified TBOR will help ensure that the IRS will continue to treat taxpayers fairly, properly, and with empathy.

The following discussion summarizes the proposals made in previous Annual Reports to Congress as they relate to the taxpayer rights enumerated in the 2007 TBOR recommendation.

### The Right to Be Informed

Currently, the right to be informed is provided to taxpayers in the Internal Revenue Code (IRC) and other federal laws.<sup>11</sup> Taxpayers have the right to know what is expected of them in terms of complying with the tax law. Taxpayers also have the right to have access to IRS procedures, policies, guidance, and other instructions to staff, to the extent permitted by law. This right includes protections and procedures under the Freedom of Information Act (FOIA),<sup>12</sup> the Privacy Act,<sup>13</sup> and IRC § 6110. It also includes clear explanations of the law and IRS procedures, in the form of tax forms and instructions, publications, notices, and correspondence, as well as oral communications. Taxpayers also have the right to be informed of the results of, and reasons for, IRS decisions about their tax matters. Enactment of the following previously recommended legislative changes would enhance the right of taxpayers to be informed.

- **Mailing Duplicate Notices to Credible Alternate Addresses.**<sup>14</sup> IRS notices often trigger the legal rights and obligations of taxpayers to take critical actions, such as contest

<sup>11</sup> See, e.g., IRC § 7521(b)(1); IRC § 7522; IRC § 6751; RRA 98 § 3501; RRA 98 § 3506. See also Publication 5, *Your Appeals Rights and How To Prepare a Protest If You Don't Agree*.

<sup>12</sup> 5 U.S.C. § 552.

<sup>13</sup> 5 U.S.C. § 552a.

<sup>14</sup> See National Taxpayer Advocate 2008 Annual Report to Congress 449-451.

a liability, challenge a notice of deficiency, or contest a lien filing, and most require the taxpayer to take the action within a specified number of days. The IRS mails these notices to the taxpayer's last known address. However, with a mobile and transitory population, the last known address contained in the IRS's Master File (typically the address shown on the most recent return) may not reflect the taxpayer's current residence.<sup>15</sup> As a result, taxpayers who are between tax return filing seasons and have not updated their addresses with the IRS or the U.S. Postal Service may not receive critical notices from the IRS. The National Taxpayer Advocate recommends that Congress direct the Secretary of the Treasury to develop procedures for checking third-party databases for credible alternate addresses prior to sending notices that establish legal rights and obligations, and when there is a credible alternate address, in addition to the notice sent to the last known address, require the IRS to mail dual confirmation letters to credible alternate addresses.<sup>16</sup>

- **Notice of Right to Collection Due Process Hearing.**<sup>17</sup> The IRS often grants extra time for those outside the United States to file other documents or respond to inquiries where important procedural rights are involved.<sup>18</sup> However, a taxpayer submitting a Collection Due Process (CDP) request from outside the country does not have this additional time. These taxpayers experience an additional burden in gathering pertinent documents and allowing for the processing and delivery of foreign mail. This exhausts a significant portion of their 30-day CDP filing window, which can result in late filing and the loss of their ability to pursue a judicial remedy. We recommend that Congress amend IRC §§ 6320 (a)(2)(B) and 6330(a)(2) and (a)(3)(B) as necessary to provide the taxpayer outside the United States an additional 30-day period to request a hearing in response to a CDP notice, and amend IRC § 6330(d)(1) to allow an additional 30-day response period to taxpayers appealing a CDP determination from outside the United States.<sup>19</sup>

### The Right to Be Assisted

Taxpayers have the right to receive prompt, courteous, and professional assistance about tax obligations, in the manner in which they are best able to understand it, and to be provided a method to lodge grievances when service is inadequate. Taxpayers have a right to expect that the tax system will attempt to keep taxpayer compliance costs at a minimum, and that assistance will be available in a timely and accessible manner and without unreasonable delays. The right of taxpayers to be assisted is articulated in the IRS mission

<sup>15</sup> See Most Serious Problem *Introduction to Diversity Issues: The IRS Should Do More to Accommodate Changing Taxpayer Demographics*, *supra*.

<sup>16</sup> IRS Office of Chief Counsel Memorandum, Ref. No. PRESP-116879-09, *Use of Dual Confirmation Letters for Address Changes of Form 941 Filers Who Use Reporting Agents or Other Third Parties* (Aug. 19, 2009).

<sup>17</sup> See National Taxpayer Advocate 2002 Annual Report to Congress 244.

<sup>18</sup> See, e.g., IRC § 6213(a) (150 days instead of the usual 90 days to petition the United States Tax Court if the notice of deficiency is addressed to a taxpayer outside the United States).

<sup>19</sup> Although the 2002 recommendation only addressed IRC § 6330, which governs hearings before levies, a similar change should be made to IRC § 6320, which governs hearings upon filing of notices of lien, so that the time periods for requesting hearings in the lien and levy context are identical.

statement<sup>20</sup> and in RRA 98.<sup>21</sup> Enacting the following previously recommended legislative changes would strengthen the right of taxpayers to be assisted by the IRS.

- **Refund Delivery Options.**<sup>22</sup> Particularly in light of the current downturn in the economy, federal tax refunds are an important source of funds for many individual taxpayers. As a result, the Department of the Treasury and the IRS need to provide all taxpayers with the ability to receive refunds as quickly and inexpensively as possible. The National Taxpayer Advocate recommends that Congress direct Treasury and the IRS to (1) develop a program to enable unbanked taxpayers to receive refunds on stored value cards (SVCs)<sup>23</sup>; and (2) conduct a public awareness campaign to give taxpayers accurate information about refund delivery options, including information about average turnaround times for lower cost and government-sponsored options.<sup>24</sup>
- **Free Basic Electronic Return Preparation and Filing.**<sup>25</sup> In 1998, Congress directed the IRS to work toward a goal of having 80 percent of all returns filed electronically by 2007.<sup>26</sup> This is a desirable goal because e-filing benefits taxpayers and the IRS alike. However, while self-preparing paper returns is free for taxpayers, e-filing may require them to pay two separate fees to a vendor — one for preparing the return electronically, plus a second fee for filing it electronically. In 2002, the IRS entered into a three-year agreement with the Free File Alliance to provide free e-filing to at least 60 percent of all taxpayers. The IRS has contractually extended its agreement with the Free File Alliance through October 30, 2014. In addition, starting in 2009, taxpayers have the option to use Free File Fillable Forms, a free federal tax preparation and e-file service available to all taxpayers regardless of income. We recommend that Congress take the next step by requiring the IRS to modify its agreement with the Free File Alliance to permit the annual evaluation of, and potential modification to, the Free File Fillable Forms program specifications.<sup>27</sup> The IRS should have the authority to determine which

<sup>20</sup> “Provide America’s taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.” IRM 1.1.1.1(1) (Mar. 1, 2006).

<sup>21</sup> See RRA 98 § 1002; RRA 98 § 3705; RRA 98 § 3709.

<sup>22</sup> See National Taxpayer Advocate 2008 Annual Report to Congress 427-441. Legislative activity incorporating this recommendation in whole or in part: S. 3215, 111th Cong. (2010); H.R. 5047 111th Cong. (2010); H.R. 4994, 111th Cong. (2010).

<sup>23</sup> The Treasury Department launched a debit card pilot program during the 2011 filing season to issue refunds via prepaid cards to up to 800,000 unbanked taxpayers. After analyzing the preliminary results of the pilot, Treasury decided to discontinue the program due to low participation rates. Eric Kroh, *Treasury Won’t Renew Debit Card Refund Program in 2012, Spokesman Confirms*, Tax Notes Today (November 1, 2011). Despite low participation in the pilot as designed, the National Taxpayer Advocate believes it is in the best interest of taxpayers and tax administration to make a government-sponsored debit card available on a nationwide basis. Thus, the IRS should evaluate the methodology of the pilot, with a particular focus on the marketing campaign, to develop a more effective marketing strategy for a future government-sponsored debit card program.

<sup>24</sup> See Most Serious Problem: *After Refund Anticipation Loans: Taxpayers Will Benefit from Improved Education About Refund Delivery Options and the Availability of a Government-Sponsored Debit Card*, *supra*.

<sup>25</sup> See National Taxpayer Advocate 2004 Annual Report to Congress 471-477. Legislative activity incorporating this recommendation in whole or in part: S. 1289, 112th Congress (2011), S. 2861 110th Cong. (2008); H.R. 5801 110th Cong. (2008); S. 1074 110th Cong. (2007); S. 1321, 109th Cong. (2005).

<sup>26</sup> RRA 98 § 2001(a)(2). In 2007, the IRS Oversight Board “approved a revised and expanded goal in 2007 that calls for 80 percent of all major individual, business, and tax exempt returns to be electronically filed by 2012.” IRS Oversight Board Electronic Filing 2011 Annual Report to Congress 3.

<sup>27</sup> See Fifth Memorandum of Understanding on Service Standards and Disputes Between the Internal Revenue Service and Free File Alliance, LLC (Oct. 20, 2009), available at [http://www.irs.gov/pub/irs-utl/signed\\_fifth\\_mou\\_between\\_irs\\_and\\_ffa.pdf](http://www.irs.gov/pub/irs-utl/signed_fifth_mou_between_irs_and_ffa.pdf) (last visited Dec. 8, 2011).

forms and worksheets must be included in the program each year as well as other features to meet the evolving needs of taxpayers. (Taxpayers who want the additional benefits of a sophisticated software program would, of course, remain free to purchase and use one.)

### The Right to Be Heard

Taxpayers have the right to raise their objections and provide additional documentation or an explanation in response to actions by the IRS, which shall consider those objections and explanations promptly and impartially. The right to be heard is articulated in several IRC sections, as well as in the Internal Revenue Manual (IRM).<sup>28</sup> Moreover, the IRS shall provide the taxpayer with an explanation of why those objections or explanations are not sufficient and what is required to better document the taxpayer's concern, where appropriate. Enactment of the following proposed legislative changes will strengthen the right of taxpayers to be heard by the IRS.

- **Math Error Authority.**<sup>29</sup> IRC § 6213(b) authorizes the IRS to assess additional tax without issuing a notice of deficiency where the adjustment is the result of a mathematical or clerical error on the tax return. Using math error authority in these circumstances allows the IRS to assess and collect the additional tax and precludes review in the United States Tax Court, if the taxpayer does not contact the IRS regarding the adjustment within 60 days of the math error notice being sent.<sup>30</sup> A legislative recommendation regarding IRS math error authority was first made in the National Taxpayer Advocate 2002 Annual Report to Congress. In this report, the National Taxpayer Advocate recommended that Congress amend IRC § 6213(g)(2) to confine the definition of mathematical and clerical error to limited and specific situations, such as: inconsistent items in which the inconsistency is determined from the face of the return; omitted items, including schedules, that must be included with the return; and items reported on the return that are numerical or quantitative and can be verified by a government entity that issues or calculates such information. The National Taxpayer Advocate also recommended that Congress repeal IRC § 6213(g)(2)(M), which authorizes the IRS to use math error summary assessment procedures for an entry on the return with respect to a qualifying child for the Earned Income Tax Credit (EITC), where the taxpayer has been identified as the non-custodial parent of that child by the Federal Case Registry of Child Support Orders established under § 453(h) of the Social Security Act. Now, in this report, the National Taxpayer Advocate has recommended that any future expansion of IRS math error authority not be granted until a complete analysis of such expansion has been conducted ensuring that it does not increase taxpayer burden, erode taxpayer rights and protections, or create IRS rework. Specifically,

<sup>28</sup> See, e.g., IRC §§ 7521(b)(1); 6213(a), 7522; IRM 4.10.8.1.1 (Aug. 11, 2006).

<sup>29</sup> See National Taxpayer Advocate 2002 Annual Report to Congress 185-197. For further discussion of Math Error Authority, see Legislative Recommendation: *Mandate that the IRS, in Conjunction with the National Taxpayer Advocate, Review Any Proposed Expanded Math Error to Protect Taxpayer Rights*, *infra*.

<sup>30</sup> IRC § 6213(b)(2)(A). When the taxpayer contacts the IRS regarding his or her disagreement of the adjustment in the notice, the IRS will abate the assessment and will continue with assessment through normal deficiency procedures.

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 satisfy specific criteria.<sup>31</sup>

- **Crediting an Overpayment Against an Unassessed, Outstanding Tax Liability.**<sup>32</sup> In August of 2007, the IRS issued Revenue Ruling 2007-51, permitting the IRS to (1) reduce refunds pursuant to IRC § 6402(a) to satisfy unassessed tax liabilities, or (2) credit a decrease in tax resulting from a carryback adjustment against an unassessed liability.<sup>33</sup> Permitting the IRS to reduce a refund to satisfy an unassessed liability inappropriately allows collection prior to assessment. Although the examples described in the revenue ruling were limited to corporations, the Office of Chief Counsel indicated that the IRS's legal right under section 6402(a) to offset a refund to unassessed liabilities is not limited to corporations.<sup>34</sup> The IRS's programming, however, generally prevents it from using offsets to collect an individual's disputed liabilities before they are assessed. Although the IRS does not currently use offsets in this manner in the individual taxpayer context, practitioners have expressed concern over the IRS's basis for concluding that it can apply IRC § 6402(a) to unassessed liabilities.<sup>35</sup> Revenue Ruling 2007-51 undermines a taxpayer's right under IRC § 6213 to challenge a proposed deficiency *before* assessment and payment of the tax. Absent compelling public policy, taxpayers, particularly low income taxpayers who often rely on refunds for basic living expenses, should be protected from this type of premature collection. If Congress shares the IRS's concern that large refunds or credits are being issued when corporations have significant unassessed liabilities and this risk is so compelling as to warrant overriding a fundamental taxpayer protection, the National Taxpayer Advocate recommends that Congress carve out a specific exception in IRC § 6402 for these circumstances.

### The Right to Pay the Correct Amount of Tax Due

Multiple IRC sections, the IRS Mission Statement, and RRA 98 detail the right of taxpayers to pay the correct amount of tax due.<sup>36</sup> Taxpayers have the right to expect that the IRS will apply the tax law "with integrity and fairness to all."<sup>37</sup> Thus, taxpayers have the right to pay only the tax legally due and to have all tax credits, benefits, refunds, and other provisions properly applied. Codifying the National Taxpayer Advocate's previously recommended

<sup>31</sup> For specifics on criteria that should be considered when evaluating proposals recommending expansion of math error authority, see Legislative Recommendation: *Mandate that the IRS, in Conjunction with the National Taxpayer Advocate, Review Any Proposed Expanded Math Error to Protect Taxpayer Rights*, *infra*, and for a discussion regarding administrative challenges faced by the IRS when math error authority is expanded beyond its traditional confines, see Most Serious Problem: *Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights*, *supra*.

<sup>32</sup> See National Taxpayer Advocate 2008 Annual Report to Congress 442-445.

<sup>33</sup> Rev. Rul. 2007-51, 2007-2 C.B. 573.

<sup>34</sup> See *IRS Maintains Legality of Revenue Ruling on Refund Offsets in Letter to Law Professor*, 2008 TNT 5-9 (Jan. 8, 2008).

<sup>35</sup> See Sam Young, *IRS Response Fails to Cool Debate over Offset Ruling*, 2008 TNT 5-2 (Jan. 8, 2008). See also David Marzahl, *Tax Preparation Group Seeks Clarification on Refund Offset Revenue Ruling*, 2007 TNT 230-23 (Nov. 29, 2007).

<sup>36</sup> See, e.g., IRC §§ 6404(a); 7122; 6015; 6402; 7524; RRA 98 § 3506; IRS Mission Statement.

<sup>37</sup> IRS Mission Statement.

changes discussed below would strengthen the right of taxpayers to pay the correct amount of tax due.

- **Clarify that taxpayers are entitled to raise innocent spouse relief as a defense in collection suits.**<sup>38</sup> Married taxpayers who file joint returns are jointly and severally liable for any deficiency or tax due.<sup>39</sup> Spouses who live in community property states and file separate returns are generally required to report half of the community income on their separate returns. IRC § 6015, sometimes referred to as the “innocent spouse” rules, provides relief, including “traditional,” “allocated,” and “equitable” relief, from joint and several liability. Similarly, IRC § 66 provides relief from the operation of community property rules. The National Taxpayer Advocate recommends that Congress expressly provide that taxpayers may raise relief under those sections as a defense in any proceeding brought under Title 26 or any case arising under Title 11 of the United States Code.
- **Amend IRC § 6050P to remove the 36-month nonpayment period from a list of triggering events requiring a creditor to issue a Form 1099-C.**<sup>40</sup> A creditor that cancels a debt is generally required to report that amount to the IRS on Form 1099-C, *Cancellation of Debt*, and a taxpayer whose debt is canceled must generally include the amount canceled in his or her income when filing a tax return. However, current Treasury regulations create a presumption that a 36-month period in which the debtor does not make a payment is a “triggering event” that requires the creditor to issue a Form 1099-C, even where the creditor is not actually discharging the debt.<sup>41</sup> Thus, the creditor may be collecting the debt even as the IRS asserts the taxpayer owes additional tax based on the reported cancellation. The National Taxpayer Advocate recommends that Congress amend IRC § 6050P to remove the 36-month regulatory “testing period” as a basis on which to issue a Form 1099-C.
- **Amend IRC § 6511 to Allow Refund Claims Past the RSED When Excess Collection Is Due to IRS Error.**<sup>42</sup> The IRS sometimes levies on taxpayer accounts in excess of the tax liability owed. If the taxpayer does not claim a refund within the statutorily-permitted time,<sup>43</sup> the IRS will not honor the claim, even if the mistake is attributable solely to IRS error and the taxpayer did not learn of the error prior to the refund statute expiration date (RSED). The National Taxpayer Advocate recommends that the IRS be required to send out annual statements to taxpayers under continuous levy showing payments received, penalties assessed, and interest charged. Alternatively, the

<sup>38</sup> See National Taxpayer Advocate 2010 Annual Report to Congress 377-382; National Taxpayer Advocate 2009 Annual Report to Congress 378-380; National Taxpayer Advocate 2007 Annual Report to Congress 549-550.

<sup>39</sup> IRC § 6013(d)(3).

<sup>40</sup> See National Taxpayer Advocate 2010 Annual Report to Congress 383-386.

<sup>41</sup> Treas. Reg. § 1.6050P-1.

<sup>42</sup> See National Taxpayer Advocate 2006 Annual Report to Congress 547-548.

<sup>43</sup> IRC § 6511(a) provides the general rule that a claim for refund must be filed within three years from the time the return was filed, or two years from the date the tax was paid, whichever period expires later.

National Taxpayer Advocate recommends that taxpayers be allowed two years from the date they learned of the excess collection to file a refund claim if the excess collection is due to IRS error.

### The Right to an Appeal (Administrative and Judicial)

Administrative and judicial appeals are crucial to the actual and perceived fairness of the tax system from the taxpayer perspective. The rights to these remedies are protected by many IRC sections, Treasury Regulations, and RRA 98.<sup>44</sup> Taxpayers have the right to be advised of and avail themselves of a prompt administrative appeal that provides an impartial review of *all* compliance actions (unless expressly barred by statute) and an explanation of the Appeals Division's decision. Taxpayers have the right to expect that Appeals personnel will generally not engage in *ex parte* communications with IRS compliance personnel except in certain permitted circumstances.<sup>45</sup> In order to further protect the rights of taxpayers to an appeal, Congress should enact the National Taxpayer Advocate's previously recommended legislative changes, discussed below.

- **Strengthen the Independence of the IRS Office of Appeals and Require at Least One Appeals Officer and Settlement Officer in Each State.**<sup>46</sup> RRA 98 provided that the IRS Office of Appeals (Appeals) should be independent from the IRS, should eliminate prohibited *ex parte* communications with the IRS, and should ensure that an appeals officer is regularly available within each state.<sup>47</sup> In recent years, Appeals has eliminated offices in several states and substituted a system of traveling Appeals officers. At the end of FY 2011, nine states and Puerto Rico had no appeals or settlement officers with a post-of-duty within their geographic borders.<sup>48</sup> Additionally at the end of FY 2011, six states had only appeals officers and no settlement officers with a post-of-duty within the state.<sup>49</sup> The National Taxpayer Advocate recommends that Congress require and fund Appeals to have at least one appeals officer and settlement officer located and regularly available within every state, the District of Columbia, and Puerto Rico, and allow taxpayer access to telephonic, correspondence, or face-to-face hearings with a local Appeals office upon request. The National Taxpayer Advocate further recommends that each Appeals office be required to maintain its own space, equipment (*e.g.*, fax machine), and mailing address separate from any co-located IRS office.

<sup>44</sup> See, *e.g.*, IRC §§ 7123; 6330; 6320; 6213; Treas. Reg. §§ 601.106; 601.103(b); RRA 98 § 1001(a)(4).

<sup>45</sup> See RRA 98 § 1001(a)(4); Rev. Proc. 2000-43, 2000-2 C.B. 404. Note that proposed changes to Rev. Proc. 2000-43 were announced in Notice 2011-62, 2011-32 I.R.B. 126.

<sup>46</sup> See National Taxpayer Advocate 2009 Annual Report to Congress 346-350.

<sup>47</sup> See RRA 98 §§ 1001(a)(4); 3465(b).

<sup>48</sup> IRS, Office of Appeals (Appeals), Onrolls Listing for Non-Supervisory Appeals and Settlement Officers (Nov. 19, 2011). Alaska, Arkansas, Idaho, Kansas, Montana, North Dakota, Rhode Island, Vermont, Wyoming, and Puerto Rico had no appeals or settlement officers at the end of FY 2011. Settlement Officers hold Collection Due Process Hearings under IRC §§ 6320 and 6330, and hear appeals of installment agreement denials and offer in compromise rejections under IRC § 7122(e).

<sup>49</sup> IRS, Office of Appeals (Appeals), Onrolls Listing for Non-Supervisory Appeals and Settlement Officers (Nov. 19, 2011). Delaware, Hawaii, Iowa, Maine, South Dakota, and West Virginia had one or more appeals officers, but no settlement officers at the end of FY 2011.

- **Collection Due Process and Uneconomical Levies.**<sup>50</sup> Before levying on property or right to property which is to be sold, the IRS must conduct a thorough investigation of the status of the property, including whether there is equity in such property or the levy is uneconomical.<sup>51</sup> Court decisions have held that an Appeals hearing officer need not verify that the IRS conducted the “equity in property” review required by IRC § 6331(j) prior to proposing a levy action that triggers a CDP hearing.<sup>52</sup> Courts have also held that the Appeals hearing officer need not take into account the uneconomical nature of the levy under the CDP “balancing” of the government’s interests against the intrusiveness of the action from the taxpayer’s perspective.<sup>53</sup> However, the failure to investigate and determine the uneconomical nature of a proposed levy action prior to a CDP hearing on the appropriateness of the levy action renders that hearing meaningless. By not weighing these two factors, the IRS fails to provide the necessary oversight of IRS collection activity that Congress intended. Thus, the National Taxpayer Advocate recommends that Congress amend IRC §§ 6330(c)(1), (c)(2)(A), and (c)(3)(C) to clarify that the Appeals hearing officer must, prior to making a determination under IRC § 6330(c)(3), consider the IRS analysis required under IRC § 6331(j) in balancing the government’s interest in efficient tax collection with the taxpayer’s legitimate concern about the intrusiveness of the proposed levy action.
- **Restructuring and Reform of Collection Due Process Provisions.**<sup>54</sup> CDP hearings afford taxpayers the opportunity to obtain meaningful review of IRS collection actions by an impartial Appeals officer and the courts, either after the initial filing of a Notice of Federal Tax Lien (NFTL) or before an initial levy on a taxpayer’s assets. The current statutory CDP rights are both under-inclusive and over-inclusive, denying judicial review of some lien and levy actions, while encouraging counterproductive behavior on the part of some taxpayers and the IRS. To enhance taxpayer protections in the tax collection process while ensuring that the IRS’s ability to collect the correct amount of tax is not unreasonably impaired, we recommend that Congress (1) require the IRS to issue a separate CDP Right to Hearing notice at the time it undertakes the first levy action with respect to a tax, specifying the levy source and the date the levy will occur and providing the taxpayer with the name and contact information of an IRS employee to contact about the levy action; and (2) codify both the IRS Collection Appeals Program (CAP) and the IRS Audit Reconsideration Process and specifically include Audit Reconsideration as an alternative to be considered at CDP hearings.

<sup>50</sup> See National Taxpayer Advocate 2006 Annual Report to Congress 551-552.

<sup>51</sup> IRC § 6331(j).

<sup>52</sup> The United States Court of Appeals for the Sixth Circuit agreed with the Commissioner’s reasoning that “[a]ll that the statute requires is that the IRS investigate the equity in a property prior to levying on it, not prior to the collection due process hearing.” *Living Care Alternatives of Utica, Inc.*, 411 F.3d 62, 628-29 (6th Cir. 2005). See also *Medlock v. U.S.*, 325 F. Supp. 2d 1064, 1079 (C.D. Cal. 2003) (stating, “According to the plain language of the relevant statutory sections [6331(f) and 6331(j)] these actions must be taken before a taxpayer’s property may be levied upon by the IRS but are prematurely raised at this stage of the collection process.”).

<sup>53</sup> “[T]here is no requirement that the government consider in its balancing analysis whether it will receive any revenue from a levy and sale, or whether the business will have to close down due to the levy and sale.” *Living Care Alternatives of Utica, Inc.*, 41 F.3d at 628 (citations omitted).

<sup>54</sup> See National Taxpayer Advocate 2005 Annual Report to Congress 447-463; National Taxpayer Advocate 2004 Annual Report to Congress 451-470.

### The Right to Certainty

Taxpayers have the right to know the tax implications of their actions and the date and circumstances under which certain actions are final (*e.g.*, the date by which a Tax Court petition must be filed, the applicable periods of limitations, the circumstances under which there will be second examinations, and the effect of closing agreements and settlements). These rights are provided for in multiple IRC sections and would be enhanced through the enactment of the National Taxpayer Advocate's previously recommended legislative changes, discussed below.<sup>55</sup>

- **Provide a Uniform Definition of a Hardship Withdrawal from Qualified Retirement Plans.**<sup>56</sup> The tax code describes over a dozen tax-advantaged plans and arrangements to encourage taxpayers to save for retirement. While these tax-advantaged retirement planning vehicles help taxpayers save, they are subject to differing sets of rules regulating eligibility, contribution limits, taxation of contributions and distributions, withdrawals, availability of loans, and portability. Particularly confusing are the rules governing certain distributions from qualified plans that are made before age 59½. While some plans allow for an early distribution when a hardship event occurs, the various plans do not have uniform "hardship withdrawal" provisions. Even if a plan allows for a hardship withdrawal, participants must deal with inconsistent rules triggering the ten percent additional tax for early withdrawal imposed by IRC § 72(t). The National Taxpayer Advocate recommends that Congress establish uniform rules on the availability and tax consequences of hardship withdrawals from qualified retirement plans, and that such distributions be exempt from the ten percent additional tax.
- **Provide a Fixed Statute of Limitations for U.S. Virgin Islands Taxpayers.**<sup>57</sup> For most U.S. citizens, the filing of a tax return with the IRS starts a three-year statute of limitations (SOL) on assessment within which the IRS must assess any deficiency.<sup>58</sup> *Bona fide* residents of the U.S. Virgin Islands (USVI) are required to pay taxes to and file with the USVI Bureau of Internal Revenue rather than the IRS if they satisfy each of the requirements of IRC § 932(c)(4). Individuals who fail to meet any of those requirements must file a Federal income tax return with the IRS. Over the years, the IRS has reached different conclusions about the extent to which USVI residents have the benefit of a SOL. In 2008, the IRS and the Treasury Department issued final regulations under IRC § 932, providing for a statute of limitations for individuals filing a USVI return and claiming to be *bona fide* residents of the USVI; such a return would be deemed to be a U.S. income tax return and thus the statute of limitations on assessment in IRC § 6501(a) would begin running from the date of filing with the USVI.<sup>59</sup> That statute of limitations, however, was only applicable to tax years ending on or after

<sup>55</sup> See, *e.g.*, IRC §§ 7481; 6501; § 6502; 6511; 6213(a); 7605(b).

<sup>56</sup> See National Taxpayer Advocate 2009 Annual Report to Congress 384-390.

<sup>57</sup> See *id.* at 391-399.

<sup>58</sup> See IRC § 6501(a).

<sup>59</sup> Treas. Reg. § 1.932-1(c)(2)(ii).

December 31, 2006. Consequently, certain taxpayers claiming to be *bona fide* residents of the USVI were not given the benefit of a SOL. The National Taxpayer Advocate recommends clarifying the law so that the filing of a return with the USVI by a person claiming to be a *bona fide* USVI resident starts the SOL to the same extent as filing with the IRS, regardless of the tax years involved.

- **Eliminate (or Reduce) Procedural Incentives for Lawmakers to Enact Tax Sunsets.**<sup>60</sup>

The IRC contains more than 150 provisions that are temporary and set to expire in tax years 2011-2020, up from about 21 in 1992.<sup>61</sup> Tax benefits have increasingly been enacted for a limited number of years in order to reduce their cost for budget-scoring purposes. Tax sunsets make it difficult for both the government and taxpayers to plan ahead, especially when there is significant uncertainty about whether Congress will extend a provision that is set to expire. The complexity and uncertainty caused by sunsets makes it more difficult for taxpayers to estimate liabilities and pay the correct amount of estimated taxes, complicates tax administration for the IRS, reduces the effectiveness of tax incentives, and may even reduce tax compliance. The National Taxpayer Advocate recommends that Congress consider several options to reduce or eliminate the procedural incentives to enact temporary tax provisions.

### The Right to Privacy

Taxpayers have the right to expect that any IRS inquiry or enforcement action will involve as little intrusion into taxpayers' lives as possible, will be limited to information relevant to the matter at hand, and will follow all due process considerations, including search and seizure protections and the provision of a collection due process hearing, where required. Enacting the National Taxpayer Advocate's previously recommended legislative changes, discussed below, would enhance and further protect a taxpayer's right to privacy.

- **Waiver of Levy Prohibition Under IRC § 6331(k).**<sup>62</sup> IRC § 6331(k) generally provides that the IRS cannot levy on a taxpayer's assets while an offer in compromise (OIC) is pending, or an installment agreement (IA) is pending or in effect. This prohibition does not apply, however, if the taxpayer files a written notice with the IRS waiving the levy restriction.<sup>63</sup> The National Taxpayer Advocate has witnessed occasions when the IRS has attempted to require a waiver in exchange for agreeing to an IA or OIC. To protect taxpayers from IRS overreaching, the National Taxpayer Advocate recommends that Congress amend IRC § 6331(k)(3)(A) to clarify that the IRS is prohibited from conditioning approval of an IA or OIC on the taxpayer's waiving the levy prohibition.

<sup>60</sup> See National Taxpayer Advocate 2008 Annual Report to Congress 397-409. Legislative activity incorporating this recommendation in whole or in part: S. 727, 112th Congress (2011).

<sup>61</sup> Cf. William G. Gale and Peter R. Orszag, Tax Policy Center, *Sunsets in the Tax Code*, 99 Tax Notes 1553 (June 9, 2003) (describing 21 tax provisions set to expire over a five-year period as of January 1992) with Joint Committee on Taxation, JCX- 2-11, *List of Expiring Federal Tax Provisions, 2010-2020* (Jan. 21, 2011) (listing 161 expiring provisions, which are all scheduled to sunset by the end of 2020, with 90 in tax year 2011 alone).

<sup>62</sup> See National Taxpayer Advocate 2008 Annual Report to Congress 446-448.

<sup>63</sup> Treas. Reg. § 301.6331-4(a)(4).

- **Levy Actions on Fixed and Determinable Rights.**<sup>64</sup> The IRS, by virtue of placing a single levy upon a taxpayer's fixed and determinable right to future benefits prior to the Collection Statute Expiration Date (CSED), can levy upon a taxpayer's retirement or disability benefits without any limitation in time. The National Taxpayer Advocate recommends that Congress restrict the IRS's ability to levy indefinitely under IRC § 6331(a) upon a taxpayer's fixed and determinable right to future retirement and disability benefits (including Social Security and private pension and disability plan benefits) to cases where the taxpayer has exhibited flagrant conduct; and exclude post-CSED accruals of penalties and interest from IRS collection when the IRS makes a pre-CSED levy upon a taxpayer's fixed and determinable rights to future payments.

### The Right to Confidentiality

Taxpayers have the right to expect that any information provided to the IRS will not be used or disclosed by the IRS unless authorized by the taxpayer or other provision of law. Taxpayers also have the right to expect that the IRS will conduct appropriate oversight over those who assist in tax administration (tax preparers, tax software providers, electronic return originators) to ensure that returns and return information are protected from unauthorized use or disclosure. Currently the right to confidentiality is protected by at least six IRC sections.<sup>65</sup> However, by enacting the following previously proposed legislative changes, Congress would enhance the taxpayer's right to confidentiality.

- **Consent-Based Disclosures of Tax Return Information Under IRC § 6103(c).**<sup>66</sup> When closing on a mortgage, for example, borrowers often must consent to disclose certain tax information to verify their income. In practice, this consent often involves signing a *blank* copy of Form 4506-T, *Request for Transcript of Tax Return*, which gives the lender access to four years of tax information for 120 days from the date on the form. However, the information is not subject to the same protection and limits on use as other taxpayer information, which raises numerous privacy concerns. The National Taxpayer Advocate recommends that IRC § 6103(c) be amended to limit the redisclosure or use of tax returns and tax return information requested through taxpayer consent solely to the extent necessary to achieve the purpose for which the consent was given by the taxpayer. Congress should further amend IRC § 6103(p)(3)(C) to require the Treasury to include in the Secretary's annual disclosure report to the Joint Committee on Taxation detailed information about the number and types of disclosures made pursuant to taxpayer consent. To deter misuse of taxpayer return information obtained through an IRC § 6103(c) consent, IRC §§ 7213A and 7431 should be amended to apply criminal and civil sanctions.

<sup>64</sup> See National Taxpayer Advocate 2006 Annual Report to Congress 527-530.

<sup>65</sup> See, e.g., IRC §§ 6103; 7216; 6713; 7803(c)(4)(A)(iv); 7602(c); 7525.

<sup>66</sup> See National Taxpayer Advocate 2007 Annual Report to Congress 554-555.

- **Disclosure of Returns and Return Information to Other Agencies — IRC Section 6103.**<sup>67</sup> In situations where another government agency requires a taxpayer’s return or return information, the National Taxpayer Advocate recommends that statutory exceptions for disclosure be limited to those rare instances in which an agency has demonstrated a compelling need for that information and it cannot be reasonably obtained from another source. All such disclosures should be subject to appropriate safeguards and procedures for maintaining the confidentiality of the tax information in the hands of another agency. The Code should specify limits on the amount and use of disclosed information, and make all violations of those limits subject to civil and criminal sanctions. Disclosure provisions should be designed to minimize access to such information by contractors. Where an agency must use contractors, the disclosures should be limited to a “fact of filing” or “match/mismatch” acknowledgement. If such a narrow disclosure provision is unworkable, then the disclosure of tax information should be limited to the number of nontax administration contractors that the IRS can adequately safeguard. Finally, every ten years, the Congress should direct the Secretary of the Treasury to review all disclosure exceptions in IRC § 6103, make recommendations about their continued necessity, including suggesting repeal where technological or private-sector advances have minimized the need for the disclosure, and report such findings and recommendations to the Joint Committee on Taxation.
- **Use and Disclosure of Tax Return Information.**<sup>68</sup> Absent a statutory or regulatory exception, IRC § 7216 provides criminal sanctions for tax return preparers disclosing or using tax return information without the taxpayer’s consent for any purpose other than tax preparation. Section 7216 of the IRC and the related regulations do not prohibit, however, tax return preparers from using or disclosing tax return information for purposes of soliciting business if the taxpayer has given written consent. Taxpayers often receive multiple forms to sign when hiring preparers. There is no real way to determine whether taxpayers gave informed consent, *i.e.*, whether taxpayers completely understand that they are authorizing the preparer to release their data to a third party, or that confidentiality of their tax return information may not be protected from redisclosure by the third party. Accordingly, Congress should amend both IRC §§ 7216 and 6713 (the civil corollary) to include clear language safeguarding the confidential nature of this information.<sup>69</sup>
- **Authorize Treasury to Issue Guidance Specific to IRC § 6713 Regarding the Use and Disclosure of Tax Return Information by Preparers.**<sup>70</sup> IRC § 6713 has historically been identified as the civil counterpart to the criminal penalty imposed on tax return

<sup>67</sup> See National Taxpayer Advocate 2003 Annual Report to Congress 232-255.

<sup>68</sup> See National Taxpayer Advocate 2006 Annual Report to Congress 496-502.

<sup>69</sup> For example, Congress should amend IRC § 7216(b)(3) to specifically require that the regulations thereunder provide the required presentation of written consents and requirements for obtaining the taxpayer’s signature on such consents. The statute should also specifically require that the regulations provide safe harbor language for written consents. Such safe harbor language should include information on consent limitations, duration of consents, and contact information to report violations.

<sup>70</sup> See National Taxpayer Advocate 2007 Annual Report to Congress 547-548.

preparers under IRC § 7216. Like IRC § 7216, it provides a broad prohibition against the use and disclosure of tax return information. Because of IRC § 6713(b)'s cross-reference to IRC § 7216(b), the current statutory framework seemingly requires exceptions for both the criminal and civil statutes or for neither. The Treasury Department is understandably reluctant to subject preparers to criminal sanctions except for egregious conduct, so it has used its regulatory authority to carve out broad exceptions from the general prohibition on the use or disclosure of tax return information set forth in IRC § 7216. The National Taxpayer Advocate believes taxpayer protections would be stronger if Treasury is given the flexibility to issue regulations applicable only to the civil penalty without concern that the criminal penalty would also apply.

- **Refine whistleblower procedures to better protect taxpayer privacy while providing necessary information to whistleblowers.**<sup>71</sup> Generally, tax return information is confidential. The circumstances under which the IRS may disclose a taxpayer's return information to a whistleblower is limited.<sup>72</sup> However, if a whistleblower appeals to the United States Tax Court the IRS's determination regarding an award, the taxpayer's return information may become public. Thus, whistleblower claims may allow public disclosure of this information without the taxpayer's knowledge or consent in proceedings to which the whistleblower — but not the taxpayer — is a party. The National Taxpayer Advocate recommends that Congress amend IRC § 7623 and other applicable provisions to require redaction of third-party return information in administrative and judicial proceedings on a whistleblower claim, with an opportunity for the taxpayer to request further redactions before disclosure.<sup>73</sup> The taxpayer would retain a subsequent right of action for civil damages for unauthorized disclosure by the whistleblower.

### The Right to Representation

Taxpayers have the right to be represented in contacts, transactions, and controversies with the IRS by an authorized representative of their choice. Moreover, taxpayers who do not have the means to afford representation may be eligible for representation by Low Income Taxpayer Clinics (LITCs) and Student Tax Clinics that provide such representation for free or for a nominal fee. The right to have representation when interacting with the IRS is acknowledged in at least three IRC sections.<sup>74</sup> By codifying the following previously proposed legislative changes, Congress would further protect and enhance a taxpayer's right to representation.

<sup>71</sup> See National Taxpayer Advocate 2010 Annual Report to Congress 396-399.

<sup>72</sup> A "whistleblower" is an individual who provides information to the IRS regarding violations of tax laws and submits a claim under IRC § 7623 for a reward. Treas. Reg. § 301.6103(n)-2.

<sup>73</sup> The Tax Court recently announced proposed amendments to its rules of practice and procedure. Under new proposed rule 345, a whistleblower can proceed anonymously in the Tax Court, and name, address, and other identifying information of the taxpayer to which the whistleblower claim relates must be redacted. The Tax Court's explanation for new proposed rule 345 cites the National Taxpayer Advocate's letter to the Tax Court, dated March 1, 2011, supporting such proposed amendment.

<sup>74</sup> See, e.g., IRC §§ 7521; 7526; 7430.

- **Amend IRC § 7430 to clarify that attorney fee awards may not be retained by the government to satisfy a litigant’s preexisting government debts.**<sup>75</sup> IRC § 7430 provides that courts may award attorneys’ fees to taxpayers who prevail against the United States in connection with the determination, collection, or refund of any tax if certain procedural requirements are met. Fee-shifting provisions like § 7430 are intended to decrease apprehension among those who feel they have been victims of unreasonable government action but who might be reluctant to challenge those actions because of the expense involved in securing representation. In 2010, the United States Supreme Court held that the attorneys’ fees awarded under the Equal Access to Justice Act<sup>76</sup> were payable to the litigant and thus subject to offset by the government to satisfy a litigant’s preexisting but unrelated government debt.<sup>77</sup> Subjecting attorney fee awards to offset for unrelated government debts of the litigant undercuts the purpose of fee-shifting statutes and creates a chilling effect on reduced fee and *pro bono* assistance. The National Taxpayer Advocate recommends that Congress amend IRC § 7430 to clarify that attorneys’ fees cannot be used to satisfy a litigant’s preexisting government debt.
- **Referral to Low Income Taxpayer Clinics.**<sup>78</sup> The National Taxpayer Advocate has discussed at length the impact that representation has on the outcome of a taxpayer’s case, particularly in EITC examinations.<sup>79</sup> One opportunity for some taxpayers to obtain representation before the IRS is through LITCs.<sup>80</sup> However, the Supplemental Standards of Ethical Conduct for Employees of the Department of the Treasury<sup>81</sup> prohibit the recommendation or referral of specific attorneys or accountants. Although IRS employees do refer taxpayers to the existence of LITCs through Publication 4134, the Office of Government Ethics’ Standards of Ethical Conduct for Employees of the Executive Branch<sup>82</sup> further limit IRS employees’ ability to refer taxpayers to specific LITCs for representation. The National Taxpayer Advocate recommends amending IRC § 7526(c) to add a special rule clarifying that notwithstanding any other provision of law, IRS employees may refer taxpayers to specific LITCs receiving funding under this section.

<sup>75</sup> See National Taxpayer Advocate 2010 Annual Report to Congress 406-409.

<sup>76</sup> 28 U.S.C. § 2412.

<sup>77</sup> *Astrue v. Ratliff*, 130 S. Ct. 2521 (2010). See also 28 U.S.C. § 2412(d).

<sup>78</sup> See National Taxpayer Advocate 2007 Annual Report to Congress 551-553. Legislative activity incorporating this recommendation in whole or in part: S. 1573, 112th Congress (2011), H.R. 5047, 111th Cong. (2010), S. 3215, 111th Cong. (2010), H.R. 4994, 111th Cong. (2010), H.R. 5719, 110th Cong. (2008).

<sup>79</sup> See *id.* at vol. 2, 94-117 (Research Report: *IRS Earned Income Credit Audits — A Challenge to Taxpayers*). In tax year 2004 nearly twice as many audited EITC taxpayers with representation were found eligible for the EITC. Similarly, taxpayers with representation retained, on average, 45 percent of the EITC compared to 25 percent for taxpayers without representation — nearly twice as much.

<sup>80</sup> See IRC § 7526. Low income taxpayer clinics provide professional representation before the IRS or in court on audits, appeals, tax collection disputes, and other issues for free or for a small fee. Some clinics can provide information about taxpayer rights and responsibilities in many different languages for individuals who speak English as a second language.

<sup>81</sup> 5 C.F.R. Part 3101.

<sup>82</sup> 5 C.F.R. Part 2635.

### The Right to a Fair and Just Tax System

Many IRC sections protect the right of taxpayers to a fair and just tax system.<sup>83</sup> Taxpayers have the right to expect that the tax system will take into consideration the specific facts and circumstances that might affect taxpayers' underlying liability, ability to pay, or ability to provide information timely (*e.g.*, by abatement of tax, penalty or interest; offers in compromise, or installment agreements; or extensions of time to file or submit information, unless statutorily prohibited). Taxpayers have the right to access to the Office of the Taxpayer Advocate for assistance. Taxpayers have the right to compensation or damages where the IRS has excessively erred, delayed, or taken unreasonable positions.<sup>84</sup> Enacting the legislative changes discussed below would enhance the right of taxpayers to a fair and just tax system.

- **Enact Tax Reform Now.**<sup>85</sup> The National Taxpayer Advocate recommends that Congress make fundamental tax reform a high priority and approach reform in a manner similar to zero-based budgeting. The starting assumption should be that all tax expenditures would be eliminated unless a compelling business case can be made that the benefits of providing a tax incentive through the Code outweigh the tax-complexity challenges that special rules create. Factors to consider in making this assessment include whether the government continues to place a priority on encouraging the activity for which the tax incentive is provided, whether the incentive is accomplishing its intended purpose, and whether a tax expenditure is more effective than a direct expenditure.
- **Strengthen Taxpayer Protections in the Filing and Reporting of Federal Tax Liens.**<sup>86</sup> The tax code authorizes the IRS to file a Notice of Federal Tax Lien in the public record when a taxpayer owes past-due taxes. The purpose is to protect the government's interests in the taxpayer's property. However, the filing of a tax lien can significantly harm the taxpayer's credit and affect his or her ability to obtain financing, find or retain a job, secure affordable housing or insurance, and ultimately pay the outstanding tax debt. For these reasons, the National Taxpayer Advocate believes the IRS should not automatically file NFTLs but instead should carefully consider and balance these competing interests when determining whether a lien filing is appropriate. Moreover, the current inconsistent NFTL reporting of different federal tax lien events by credit reporting agencies may create unnecessary financial distress for taxpayers without furthering the government's overriding and compelling interest in ensuring the taxpayers' future compliance. The National Taxpayer Advocate recommends that Congress amend the tax code to provide clear and specific guidance about the factors the IRS

<sup>83</sup> See, *e.g.*, IRC §§ 6404(a); 6404(e); 7122; 6159; 7811; 6511(h).

<sup>84</sup> See, *e.g.*, IRC §§ 6673(a)(2); 7430.

<sup>85</sup> See National Taxpayer Advocate 2010 Annual Report to Congress 365-372 and National Taxpayer Advocate 2005 Annual Report to Congress 375-380. Legislative activity incorporating this recommendation in whole or in part: S. 727, 112th Congress (2011).

<sup>86</sup> See National Taxpayer Advocate 2009 Annual Report to Congress 357-364. Legislative activity incorporating this recommendation in whole or in part: H.R. 6439, 111th Congress (2010), H.R. 5047, 111th Congress (2010), S. 3215, 111th Congress (2010).

must consider in making NFTL filing determinations. The National Taxpayer Advocate also recommends requiring pre-filing administrative review of IRS lien determinations by the IRS Office of Appeals, permitting taxpayers to bring civil actions for damages in connection with improper NFTL filings or the IRS's failure to make the required NFTL determinations, and amending the Fair Credit Reporting Act<sup>87</sup> to set specific time-frames for reporting derogatory lien information on credit reports.

- **Revise the willfulness component of the trust fund recovery penalty.**<sup>88</sup> Employers are generally required to withhold employment taxes and certain types of excise taxes, often called “trust fund” taxes, from payments to employees. IRC § 6672 provides for the assessment of a Trust Fund Recovery Penalty (TFRP) against defined “responsible persons” when these monies are not paid as required. To establish liability for this penalty, the IRS must conclude that the failure to pay the trust fund taxes was willful. Willfulness is established if the person had knowledge of the employer’s obligation to pay the taxes and knew the funds were being used for other purposes. The statute does not contain a “reasonable cause” exception, nor does it treat the delinquency differently if it was caused by a third-party bad act such as mismanagement or embezzlement by an employee or third-party payor. The National Taxpayer Advocate recommends that Congress amend IRC § 6672 to provide that the conduct of a responsible person who obtains knowledge of trust fund taxes not being timely paid because of an intervening bad act shall not be deemed willful if the delinquent business: (1) promptly makes payment arrangements to satisfy the liability based upon the IRS’s determination of the minimal working capital needs of the business, and (2) remains current with payment and filing obligations.
- **Eliminate the Suspension of the Collection Statute During Qualified Hospitalization Resulting from Service in a Combat Zone.**<sup>89</sup> IRC § 7508(a) generally provides for the suspension of collection activities and of the Collection Statute Expiration Date (CSED) under IRC § 6502 while a taxpayer is continuously hospitalized from an injury sustained during service in a combat zone. The IRS has administrative discretion to suspend collection activity against civilians during periods of hospitalization but is not required to suspend the CSED for these taxpayers. As a result, U.S. military personnel may be placed at a disadvantage compared to civilians, because civilians may receive the benefit of deferred collection action without having to agree to extend the CSED beyond ten years, while the CSED is statutorily extended beyond ten years for military personnel. To protect individuals serving in combat from an unnecessary suspension of the CSED and to treat these individuals consistently with civilian taxpayers, the National Taxpayer Advocate recommends amending IRC § 7508(a) to eliminate the suspension of the CSED.

<sup>87</sup> 15 U.S.C. §§ 1681-1681x.

<sup>88</sup> See National Taxpayer Advocate 2010 Annual Report to Congress 400-405.

<sup>89</sup> See National Taxpayer Advocate 2009 Annual Report to Congress 381-383.

- **Repeal the Alternative Minimum Tax for individuals.**<sup>90</sup> Few people think of having children or living in a high-tax state as tax-avoidance maneuvers, but under the unique logic of the Alternative Minimum Tax (AMT)<sup>91</sup>, that is how those actions are treated. The AMT effectively requires taxpayers to compute their taxes twice — once under the regular rules and again under the AMT rules — and then pay the higher of the two amounts. The regular tax rules allow taxpayers to claim tax deductions for each dependent (recognizing the costs of maintaining a household and raising a family) and for taxes paid to state and local governments (reducing “double taxation” at the federal and state levels), but the AMT rules disallow those deductions. An estimated 77 percent of all additional income subject to tax under the AMT is attributable to the disallowance of deductions for dependents and state and local tax payments.<sup>92</sup> The AMT computations are also extremely burdensome. The National Taxpayer Advocate recommends that Congress repeal the AMT for individuals.
- **Measures to Address Noncompliance in the Cash Economy.**<sup>93</sup> Income from the “cash economy” — income from legal activities that is not reported to the IRS by third parties — is the type of income most likely to go unreported. Unreported income from the cash economy is probably the single largest component of the tax gap, likely accounting for over \$100 billion per year. Because significant noncompliance by some taxpayers is not fair to those who timely pay their taxes, Congress and the IRS must do more to address this problem. We can improve voluntary compliance by making it easier for taxpayers to understand and meet their tax obligations, and by enhancing the tools available to the IRS for enforcing the tax laws when necessary, in ways that are minimally intrusive, impose the least possible burden, and protect taxpayer rights.
- **De Minimis Apology Payments.**<sup>94</sup> The authority to make *de minimis* apology payments to taxpayers is a mechanism that would help restore taxpayer faith in the tax system when a taxpayer has been seriously mistreated by the IRS. This authority, vested solely in the National Taxpayer Advocate, would be nondelegable. The National Taxpayer Advocate, at her discretion, would be authorized to make a *de minimis* payment to a taxpayer where the taxpayer has incurred excessive expense or experienced

<sup>90</sup> See National Taxpayer Advocate 2008 Annual Report to Congress 356-362; National Taxpayer Advocate 2004 Annual Report to Congress 383-385; National Taxpayer Advocate 2001 Annual Report to Congress 166-177. Legislative activity incorporating this recommendation in whole or in part: S. 727, 112th Congress (2011), S. 3018, 111th Cong. (2010), S. 932, 111th Cong. (2009), H.R. 782, 111th Cong. (2009), H.R. 240, 111th Cong. (2009), S. 2293, 110th Cong. (2007), H.R. 3970, 110th Cong. (2007), H.R. 1942, 110th Cong. (2007), S. 14, 110th Cong. (2007), S. 1040, 110th Cong. (2007), H.R. 1365, 110th Cong. (2007), S. 55, 110th Cong. (2007), H.R. 3841, 109th Cong. (2005), H.R. 2950, 109th Cong. (2005), S. 1103, 109th Cong. (2005), H.R. 1186, 109th Cong. (2005), H.R. 4164, 108th Cong. (2004), H.R. 4131, 108th Cong. (2004), H.R. 3060, 108th Cong. (2003), S. 1040, 108th Cong. (2003), H.R. 1233, 108th Cong. (2003), H.R. 43, 108th Cong. (2003), H.R. 5166, 107th Cong. (2002), S. 616, 107th Cong. (2002), H.R. 437, 107th Cong. (2001).

<sup>91</sup> IRC § 55.

<sup>92</sup> See Tax Policy Center, Tax Facts: AMT Preference Items 2002, 2004-2006 (citing unpublished tabulations from the Office of Tax Analysis, Department of the Treasury), available at [http://www.taxpolicycenter.org/taxfacts/Content/PDF/amt\\_preference.pdf](http://www.taxpolicycenter.org/taxfacts/Content/PDF/amt_preference.pdf).

<sup>93</sup> See National Taxpayer Advocate 2007 Annual Report to Congress 490-502. Legislative activity incorporating this recommendation in whole or in part: Pub. L. No. 111-148 § 9006, 124 Stat. 119, 855 (Mar. 23, 2010).

<sup>94</sup> *Id.* at 478-498. Legislative activity incorporating this recommendation in whole or in part: S. 1289, 112th Congress (2011), S. 3795, 111th Congress (2010).

undue burden as a result of an IRS mistake, action, or failure to act. The National Taxpayer Advocate's decision with respect to an award under this authority would not be appealable or reviewable. To be eligible for such a payment, the taxpayer would have to meet established criteria. The National Taxpayer Advocate recommends that Congress amend IRC § 7811 to grant the National Taxpayer Advocate the discretionary, nondelegable authority to compensate taxpayers where the action or inaction of the IRS has caused excessive expense or undue burden to the taxpayer, and the taxpayer meets the IRC § 7811 definition of significant hardship.

- **Effective Tax Administration Offers in Compromise.**<sup>95</sup> In 1998, Congress authorized the IRS to develop guidelines for determining whether an offer in compromise is adequate and should be accepted to resolve a dispute.<sup>96</sup> The legislative history indicates that Congress intended that the IRS compromise tax debts based upon factors such as equity, public policy and hardship in cases where doing so would promote the effective administration of the tax laws (ETA offers).<sup>97</sup> However, the IRS has interpreted the congressional authorization narrowly so that, for example, the IRS group charged with evaluating such offers accepted only 27 ETA offers based upon equity or public policy in FY 2011.<sup>98</sup> Over the years the IRS has clarified and expanded the guidance concerning ETA offers.<sup>99</sup> Nonetheless, the IRS's continuing reluctance to compromise for a reasonable amount in inequitable situations may lead taxpayers to disregard the law or erode their faith in the fairness of the tax system. We recommend that Congress provide more specific guidance to the IRS to ensure that offers submitted under a new "Equitable Considerations" standard are accepted in a broader array of cases.

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<sup>95</sup> See National Taxpayer Advocate 2004 Annual Report to Congress 432-450.

<sup>96</sup> RRA 98 § 3462(a).

<sup>97</sup> H.R. Rep. No. 105-599, at 289 (1998).

<sup>98</sup> Email from Small Business/Self-Employed Division OIC Program Manager, on file with TAS.

<sup>99</sup> See Treas. Reg. §§ 301.7122-1(b)(3) and -1(c)(3) (promulgated on July 18, 2002). See also IRM 5.8.11, *Effective Tax Administration* (Sept. 23, 2008).

## Appendix 1: TAXPAYER BILL OF RIGHTS

### National Taxpayer Advocate Partial Analysis of Subordinate Rights and Obligations

#### TAXPAYER RIGHTS

##### 1. The Right to be Informed

- a. IRC § 7521(b)(1): Publication 1: Explanation of rights as taxpayer.
- b. RRA 98, Publication 5: Explanation of Appeals process, and Publication 594: Explanation of the IRS Collection process.
- c. IRC § 7522: Content of tax due, deficiency, and other notices.
- d. IRC § 6751: Notice of penalty must include explanation of the computation.
- e. FOIA and e-FOIA, and requirement of disclosure of instructions to staff (Internal Revenue Manual).
- f. All Code sections that require Secretary to issue guidance.
- g. IRC § 6110: Public inspection of written determinations, including Chief Counsel advice.
- h. RRA 98 § 3501: Explanation of joint and several liability.
- i. RRA 98 § 3506 and Prop. Treas. Reg. § 301.6159-1(h): Annual statement of installment agreement balance and payments made during the year.
- j. IRC § 6402(k): Statement of reason for refund disallowance.

##### 2. The Right to be Assisted

- a. RRA 98 § 1002: The IRS shall review and restate its mission to place a greater emphasis on serving the public and meeting taxpayers' needs.
- b. IRS Mission Statement: Provide America's taxpayers top quality service by helping them to understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.
- c. RRA 98 § 3705: IRS correspondence must include name, phone number, and unique identifying number of an IRS employee that the taxpayer may contact with respect to that correspondence.
- d. RRA 98 § 3709: Listing of IRS local telephone numbers and addresses in telephone book for area.

### 3. The Right to be Heard

- a. IRC § 7521(b)(1): Rights under audit process.
- b. IRM 4.10.8.1.1: Audit reports should contain all information necessary to ensure clear understanding of the adjustments and document how tax liability was computed.
- c. IRC § 6402(k): Statement of reason for refund disallowance. See S. Rep. No. 105-174, at 97: “The Committee believes that taxpayers are entitled to an explanation of the reason for the disallowance or partial disallowance of a refund claim so that the taxpayer may appropriately respond to the IRS.”
- d. IRC § 6213(b): Math and clerical error summary assessment authority: taxpayer has 60 days after notice to challenge the assessment and request that deficiency procedures apply.
- e. IRC § 7522: Content of tax due, deficiency, and other notices.

### 4. The Right to Pay the Correct Amount of Tax Due

- a. IRS Mission Statement: Provide America’s taxpayers top quality service by helping them to understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.
- b. “Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury.” *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934) (citations omitted), *aff’d*, 293 U.S. 465 (1935).
- c. IRC § 6404(a): The Secretary may abate tax where excessive in amount, barred by statutes of limitations, or erroneously or illegally assessed.
- d. IRC § 7122: Offer in compromise based on doubt as to liability.
- e. IRC § 6015: Relief from joint and several liability.
- f. IRC § 6402: Administrative claim for refund (amended return or other claim).
- g. IRC § 7524: Annual notice of tax delinquency.
- h. RRA 98 § 3506 and Prop. Treas. Reg. § 301.6159-1(h): Annual statement of installment agreement balance and payments made during the year.

### 5. The Right to an Appeal (administrative and judicial)

- a. IRC § 7123: Appeals dispute resolution procedures, including early referral, mediation, and arbitration.
- b. RRA 98 § 1001(a)(4): The Commissioner shall establish an independent and impartial Appeals function, including ex parte rules.
- c. Rev. Proc. 2000-43: Ex parte rules.

- d. Treas. Reg. § 601.106: Appeals functions.
- e. Treas. Reg. § 601.103(b): Where taxpayer does not agree to Exam's proposed assessment, taxpayer is afforded appeal rights.
- f. Treas. Reg. § 601.103(c)(1): Taxpayer is given the opportunity to request an Appeals conference.
- g. IRC §§ 6330 & 6320: Collection due process hearings before an independent and impartial Appeals officer.
- h. IRC § 7122(e): Independent administrative review before rejection of offer in compromise or an installment agreement, and appeal from rejection of offer in compromise or installment agreement.
- i. IRC § 6159(e): Independent administrative review of terminations of installment agreements.
- j. IRC § 6212: Statutory notice of deficiency.
- k. IRC § 6213: Petition to U.S. Tax Court.
- l. IRC § 7428: Declaratory judgment for IRC § 501(c)(3) organizations.
- m. IRC § 7422: Refund suit.

## 6. The Right to Certainty

- a. IRC § 7481: Finality of U.S. Tax Court decision.
- b. IRC § 6501: Limitations on assessment and collection (statute of limitations).
- c. IRC § 6502: Limitations on collection after assessment.
- d. IRC § 6511: Limitations on claim for credit or refund (statute of limitations).
- e. IRC § 6213: Statutory notice of deficiency (assessment after expiration of 90 days and no petition to U.S. Tax Court filed).
- f. IRC § 6213(a): IRS must put actual date of deadline to file petition to U.S. Tax Court in statutory notice of deficiency.
- g. IRC § 7605(b): Restrictions on examination of taxpayer: no unnecessary exams or meetings and only one inspection for taxable year unless taxpayer requests it or after IRS investigates and notifies taxpayer in writing that the second exam is necessary.

## 7. The Right to Privacy (to be free from unreasonable searches and seizures)

- a. IRC § 6331: Levy and distraint rules.
- b. IRC § 6331(j): Procedures for administrative seizures of property.
- c. RRA 98 § 3421: Managerial approval of continuous levies.
- d. IRC § 6340: Accounting of proceeds of sale of property.

- e. IRC § 6334: Property exempt from levy.
- f. IRC § 6335: Sale of seized property.
- g. IRC §§ 6330 & 6320: Collection due process hearings (hearing before first levy with respect to tax; hearing after filing of notice of federal tax lien).

## 8. The Right to Confidentiality

- a. IRC § 6103: Confidentiality of taxpayer returns and tax return information.
- b. IRC §§ 7216 & 6713: Criminal and civil penalties for disclosure or use of tax return information by return preparer.
- c. IRC § 7803(c)(4)(A)(iv): Discretion of local taxpayer advocate not to disclose to the IRS the fact that taxpayer has contacted the Taxpayer Advocate Service (TAS) or any information provided by the taxpayer to TAS.
- d. IRC § 7602(c): Third party contacts: IRS must inform the taxpayer of intent to make third party contacts and provide list of contacts upon request.
- e. IRC § 7525: Confidentiality privilege for federally authorized tax practitioners (extending confidentiality to non-attorney Circular 230 practitioners in disputes before the IRS) to the extent common law attorney-client privilege applies.

## 7. The Right to Representation

- a. IRC § 7521(c): Any attorney, certified public accountant, enrolled agent, enrolled actuary, or any other person permitted to represent the taxpayer before the IRS who is not disbarred or suspended from practice before the IRS may submit a written power of attorney to represent the taxpayer before the IRS.
- b. IRC § 7521: An IRS officer or employee cannot require the taxpayer to attend an interview where represented by a power of attorney, unless pursuant to a summons.
- c. IRC § 7526: Low Income Taxpayer Clinics.
- d. IRC § 7430: Awarding of attorneys fees and administrative/litigation costs.

## 8. The Right to a Fair and Just Tax System

- a. IRC § 6404(a): The Secretary may abate tax where excessive in amount, barred by statutes of limitations or erroneously or illegally assessed.
- b. IRC § 6404(e): Abatement of interest attributable to unreasonable errors or delays by the IRS.
- c. Abatement of penalty for reasonable cause — *e.g.*, IRC § 6651 (failure to pay/failure to file penalties); IRC § 6656 (failure to deposit penalty); and IRC § 6694 (return preparer penalties).

- d. IRC § 7122: Offers in compromise based on doubt as to collectibility, doubt as to liability, economic hardship, equity, and public policy.
- e. IRC § 6159: Installment agreements, including guaranteed installment agreements.
- f. IRC §§ 7803 & 7811: Office of the Taxpayer Advocate, National Taxpayer Advocate, and Taxpayer Assistance Orders.
- g. IRC § 6511(h): Tolling of the statute of limitations for refund claims during periods of taxpayer's incapacity.

## TAXPAYER OBLIGATIONS

### 1. The Obligation to be Honest

- a. IRC § 6065: Verification of returns: Any return, statement, declaration, or other document required to be made under any provision of the internal revenue laws or regulations shall contain or be verified by written declaration made under penalties of perjury.
- b. IRC § 6663: Fraud penalty.
- c. IRC § 7206: Fraud and false statements (criminal penalty — felony: fine or imprisonment or both).
- d. IRC § 7207: Fraudulent returns, statements, or other documents (criminal penalty — fine or imprisonment or both).
- e. IRC § 7203: Willful failure to file return, supply information, or pay tax (criminal penalty — misdemeanor or felony: fine or imprisonment or both).

### 2. The Obligation to be Cooperative

- a. IRC § 7203: Willful failure to file return, supply information, or pay tax (criminal penalty — misdemeanor or felony: fine or imprisonment or both).
- b. IRC § 7491(a)(2)(B): Burden of proof: If a taxpayer is cooperative during a court proceeding (*i.e.*, maintained all records required under the Internal Revenue Code and cooperated with reasonable requests for witnesses, information, etc.), the burden of proof shifts to the IRS with respect to any factual issue relevant to the proceeding.

### 3. The Obligation to Provide Accurate Information and Documents on Time

- a. IRC § 6071: Time for filing returns and other documents.
- b. IRC § 6651(a)(1): Penalty for failure to file tax return.
- c. IRC § 7203: Willful failure to file return, supply information, or pay tax (criminal penalty — misdemeanor or felony: fine or imprisonment or both).

- d. IRC § 7602: Examination of books and witnesses (criminal penalty — misdemeanor or felony: fine or imprisonment or both): authority to issue summons for books, papers, records or other data, and authority to issue summons for a person to appear before the IRS.

#### **4. The Obligation to Keep Records**

- a. IRC § 6001: Notice or regulations requiring records, statements, and specific returns: “Every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe.”
- b. IRC § 274(d): Special substantiation required for entertainment, travel, meals and lodging, and listed property expenses.

#### **5. The Obligation to Pay Taxes on Time**

- a. IRC § 6651(a)(2): Penalty for failure to pay tax.
- b. IRC § 6656: Penalty for failure to make deposits of tax.
- c. IRC § 6654: Penalty for failure by individual to pay estimated income tax.
- d. IRC § 6672: Penalty for failure to collect and pay over tax, or attempt to evade or defeat tax (known as the trust fund recovery penalty (TFRP)).

LR  
#2**Restrict Access to the Death Master File****PROBLEM**

Tax-related identity theft is a growing problem — for its victims, for the IRS, and when Treasury funds are improperly paid to the perpetrators, for all taxpayers. In fiscal year (FY) 2011, the IRS’s centralized Identity Protection Specialized Unit (IPSU) received more than 226,000 cases, a 20 percent increase over FY 2010.<sup>1</sup> In addition, the Taxpayer Advocate Service received over 34,000 identity theft cases in that time, a 97-percent increase over FY 2010.<sup>2</sup>

In a relatively new tactic, some identity thieves are filing tax returns that claim the dependency exemption and various tax credits for deceased individuals. The IRS began to filter out these decedent schemes in April 2011 and has since stopped payment for more than 200,000 questionable returns claiming refunds estimated at more than \$850 million.<sup>3</sup>

Identity thieves have found that Social Security numbers (SSNs) and other personal information of the deceased is easily accessible. One might be surprised to learn that the federal government itself is one source of this information. The Social Security Administration (SSA) maintains a “Death Master File” (DMF) containing the full name, SSN, date of birth, date of death, and the county, state, and ZIP code of the last address on record of decedents.<sup>4</sup> DMF data is updated weekly and made available to the public. Today, anyone can quickly find a number of websites (including genealogy sites) that publish DMF information free or for a nominal fee.<sup>5</sup>

**EXAMPLE**

Aaron and Belinda lose their newborn baby Chloe to Sudden Infant Death Syndrome in August 2010. Distraught and devastated, the couple dutifully reports the death of their child to the SSA, which enters her full name, complete SSN, date of birth, date of death, and address into the DMF.

Zoe is part of an organized crime network. She has heard that filing falsified tax returns is a lucrative endeavor and even paid \$200 to attend a seminar by one of her associates on how to obtain personally identifiable information. As instructed, Zoe visits a for-profit

<sup>1</sup> IRS, *IPSU Identity Theft Report* (Oct. 1, 2011); IRS, *IPSU Identity Theft Report* (Oct. 2, 2010); IRS, *IPSU Identity Theft Report* (Oct. 3, 2009).

<sup>2</sup> In FY 2010, TAS opened 17,291 stolen identity (primary issue code 425) cases. In FY 2011, the number jumped to 34,006. Taxpayer Advocate Management Information System (TAMIS) (Oct. 31, 2011).

<sup>3</sup> TAS notes from IRS Decedent Schemes conference call (June 16, 2011).

<sup>4</sup> See Office of the Inspector General, SSA, *Personally Identifiable Information Made Available to the General Public Via the Death Master File*, A-06-08-18042 (June 2008).

<sup>5</sup> See Boston Herald, *Sandwich Parents Are Twice Robbed* (Nov. 27, 2011); Scripps Howard News Service, *ID Thieves Cashing in on Dead Children’s Information* (Nov. 3, 2011).

genealogy website that purchases DMF data and makes it available in unredacted form at no cost. By the end of the day, Zoe obtains the names, SSNs, and addresses of dozens of deceased individuals. She uses children's names to maximize the available credits, and one of the names she selects is Chloe's. In January 2011, Zoe files a tax return claiming Chloe as a qualifying child for the child tax credit, dependency exemption, and earned income tax credit.

In April 2011, Aaron and Belinda are still too distraught at the thought of Chloe's death to file their tax return and seek an extension. By August, they are ready to move on with their lives, and they file the return. In October 2011, Aaron and Belinda receive a notice from the IRS informing them that someone else claimed Chloe as a dependent for the 2010 tax year. Aaron and Belinda spend the rest of 2011 corresponding with the IRS to prove Chloe was their daughter. During the course of their research, Aaron and Belinda are shocked to discover how easy it is for anyone to access Chloe's personal information, including her full SSN, date of birth, and address.

## RECOMMENDATION

The National Taxpayer Advocate recommends that Congress enact legislation to restrict access to certain personally identifiable information in the DMF. The National Taxpayer Advocate is not recommending a specific approach at this time, but outlines below several available options.

## PRESENT LAW

The Freedom of Information Act (FOIA) provides that any person has a right, enforceable in court, to obtain access to federal agency records.<sup>6</sup> In crafting FOIA, Congress recognized the importance of allowing citizen access to government information. However, Congress also understood the government's need to keep some information confidential, including private information about individuals who might be mentioned in federal files, and thus included nine exemptions in the law.<sup>7</sup>

Personal privacy interests are protected by two exemptions within FOIA. Section 552(b)(6) protects information about individuals in "personnel and medical files and similar files" when the disclosure of such information "would constitute a clearly unwarranted invasion of personal privacy." Section 552(b)(7)(C) relates to information compiled for law enforcement purposes and protects personal information when disclosure "could reasonably be expected to constitute an unwarranted invasion of personal privacy."

The challenge for the courts has been balancing the public's interest in release of the records in question against the privacy interest of the individuals involved. In 1980, the

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<sup>6</sup> See 5 USC § 552.

<sup>7</sup> See 5 USC § 552(b).

United States District Court for the District of Columbia entered a consent judgment in a FOIA lawsuit that required the SSA to disclose the SSN, surname, and date of death (if available) of deceased Social Security beneficiaries once a year upon the request of the plaintiff in the case.<sup>8</sup> Subsequently, the SSA decided to create the DMF, which contains the full name, SSN, date of birth, date of death, and the county, state, and ZIP code of the last address on record, and to provide it on a weekly basis.<sup>9</sup>

In 1989, the Supreme Court clarified that the purpose of FOIA is to enable citizens to find out “what their government is up to” and that this purpose “is not fostered by disclosure of information about private citizens that is accumulated in various government files but that reveals little or nothing about an agency’s own conduct.”<sup>10</sup> The DMF contains personal records of millions of deceased individuals but such records do not reveal much, if anything, about the SSA’s own conduct.<sup>11</sup>

An additional challenge for the courts has been assessing the privacy interest of the deceased. While the death of the subject of personal information diminishes to some extent the privacy interest in that information, courts have held that it does not extinguish that interest.<sup>12</sup> In *Accuracy in Media, Inc. v. Nat’l Park Service*, the U.S. Court of Appeals for the District of Columbia “squarely rejected the proposition that FOIA’s protection of personal privacy ends upon the death of the individual depicted.”<sup>13</sup>

In 2004, the Supreme Court fully recognized that surviving family members also enjoy a privacy interest that must be considered when analyzing the release of agency records as it relates to Exemption 7(C).<sup>14</sup> The U.S. Court of Appeals for the District of Columbia has recognized that the privacy interests of relatives apply to Exemption 6 of FOIA.<sup>15</sup>

Given that (1) the type of information the DMF holds does not reveal much about “what the government is up to,” (2) there is a real threat that identity thieves can easily misuse the information contained in the DMF to claim improper tax benefits, and (3) the victims’ families may suffer emotional and financial harm as they deal with the aftermath of identity theft, we think a court, after conducting the requisite balancing test, might allow the SSA to shield DMF information from disclosure.

<sup>8</sup> See *Perholtz v. Ross*, Civil Action No. 78-2385 and 78-2386, U.S. District Court for the District of Columbia (Apr. 11, 1980).

<sup>9</sup> See Office of the Inspector General, SSA, *Personally Identifiable Information Made Available to the General Public Via the Death Master File*, A-06-08-18042 (June 2008).

<sup>10</sup> *Dep’t of Justice v. Reporters Comm. for Freedom of Press*, 489 U.S. 749, 772-73 (1989).

<sup>11</sup> We acknowledge that there may be some value in accessing the DMF to gain insight into the SSA. For example, an enterprising reporter could utilize DMF information to show that the SSA’s records are grossly inaccurate by tracking down how many of the people listed there are actually still living. This may show that the SSA’s method of recordkeeping is seriously flawed. However, one could make such a finding even with partial access to the DMF or if access was delayed a couple of years.

<sup>12</sup> *Schrecker v. Dep’t of Justice*, 254 F.3d 162, 166 (D.C. Cir. 2001).

<sup>13</sup> *Accuracy in Media, Inc. v. Nat’l Park Serv.*, 194 F.3d 120, 123 (D.C. Cir. 1999) (relating to suicide of White House official Vince Foster).

<sup>14</sup> *National Archives & Records Admin. v. Favish*, 541 U.S. 157, 169 (2004) (finding that “well-established cultural tradition acknowledging a family’s control over the body and death images of the deceased has long been recognized at common law” with respect to suicide of White House official Vince Foster).

<sup>15</sup> *New York Times v. NASA*, 920 F.2d 1002, 1005 (D.C. Cir. 1990) (*en banc*).

## REASONS FOR CHANGE

The National Taxpayer Advocate is appalled that the federal government is making sensitive personal information so readily available to those who steal the identities of deceased individuals and add to the burden and heartbreak facing their survivors. Perhaps most worrisome, the DMF contributes to tax-related identity theft by providing the date of birth and SSN, 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 problem. Today, heightened identity theft not only imposes a considerable hardship on victims or their families, but it also costs the government money and resources. Moreover, much of the case law affecting the public-private analysis had not yet been established in 1980, especially the narrowing of the public interest to be served by the disclosed information. 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 (such as pension administrators who rely on DMF data to terminate payments and genealogists), there is a compelling public interest in keeping such information out of the public domain.

Recently, several genealogy websites have voluntarily agreed to curtail the availability of the Death Master File information. Ancestry.com announced in December 2011 that it will no longer display SSNs for anyone who has passed away within the past ten years.<sup>16</sup> RootsWeb.com, another genealogy site affiliated with Ancestry.com, states that it will not share information from the DMF “due to sensitivities around the information in this database.”<sup>17</sup> While these voluntary changes should make it more difficult for identity thieves to file false tax returns, the National Taxpayer Advocate requests that Congress enact legislation to restrict access to the DMF to those with a legitimate need for such sensitive information.

## EXPLANATION OF RECOMMENDATION

Congress could take one of several approaches to restrict access to the DMF. One approach is to create an exemption under FOIA, which is proposed in S. 1534.<sup>18</sup> This bill would restrict who can access the DMF and impose penalties for unauthorized re-disclosure. Recipients of the DMF would be required to certify that they have a legitimate

<sup>16</sup> See Ancestry.com, *Why Was the Social Security Death Index Recently Changed?*, [http://ancestry.custhelp.com/cgi-bin/ancestry.cfg/php/enduser/sab\\_answer.php?p\\_faqid=5420&p\\_created=1323809913&p\\_sid=utw11BLk&p\\_accessibility=&p\\_redirect=&p\\_lva=&p\\_sp=cF9zcmNoPTEmcF9zb3J0X2J5PSZwX2dyaWRzb3J0PSZwX3Byb2RzPSZwX2NhdHM9JnBfcHY9JnBfY3Y9JnBfcGFnZT0x&p\\_li=&p\\_topview=1](http://ancestry.custhelp.com/cgi-bin/ancestry.cfg/php/enduser/sab_answer.php?p_faqid=5420&p_created=1323809913&p_sid=utw11BLk&p_accessibility=&p_redirect=&p_lva=&p_sp=cF9zcmNoPTEmcF9zb3J0X2J5PSZwX2dyaWRzb3J0PSZwX3Byb2RzPSZwX2NhdHM9JnBfcHY9JnBfY3Y9JnBfcGFnZT0x&p_li=&p_topview=1) (last visited Dec. 19, 2011).

<sup>17</sup> See About.com, *Genealogy Sites Pressured Into Removing SSDI*, <http://genealogy.about.com/b/2011/12/16/genealogy-sites-pressured-into-removing-ssdi.htm> (last visited Dec. 19, 2011); Ancestry.com, *Why Was the Social Security Death Index Recently Changed?*, [http://ancestry.custhelp.com/cgi-bin/ancestry.cfg/php/enduser/sab\\_answer.php?p\\_faqid=5420&p\\_created=1323809913&p\\_sid=utw11BLk&p\\_accessibility=&p\\_redirect=&p\\_lva=&p\\_sp=cF9zcmNoPTEmcF9zb3J0X2J5PSZwX2dyaWRzb3J0PSZwX3Byb2RzPSZwX2NhdHM9JnBfcHY9JnBfY3Y9JnBfcGFnZT0x&p\\_li=&p\\_topview=1](http://ancestry.custhelp.com/cgi-bin/ancestry.cfg/php/enduser/sab_answer.php?p_faqid=5420&p_created=1323809913&p_sid=utw11BLk&p_accessibility=&p_redirect=&p_lva=&p_sp=cF9zcmNoPTEmcF9zb3J0X2J5PSZwX2dyaWRzb3J0PSZwX3Byb2RzPSZwX2NhdHM9JnBfcHY9JnBfY3Y9JnBfcGFnZT0x&p_li=&p_topview=1) (last visited Dec. 19, 2011); Scripps Howard News Service, *Genealogy Sites Remove Social Security Numbers of Deceased* (Dec. 15, 2011), available at <http://www.abcactionnews.com/dpp/news/national/genealogy-sites-remove-social-security-numbers-of-deceased>.

<sup>18</sup> Identify Theft and Tax Fraud Prevention Act, S. 1534, 112th Cong. § 9 (1st Sess. 2011).

fraud-prevention interest in accessing the DMF and be subject to a penalty of \$1,000 for re-disclosure or misuse of the information.<sup>19</sup>

Alternatively, Congress could adopt the approach it uses to govern the confidentiality and disclosure of tax return information. In that situation, Congress established a general rule that tax return information will be kept confidential and has delineated a number of exceptions to the rule.<sup>20</sup> This approach could produce the same result as S. 1534, allowing the government to provide DMF information to entities with a demonstrated fraud-prevention purpose and imposing significant penalties for unauthorized re-disclosures. It could also make all or substantially all DMF information public after a specified number of years so that genealogists may access it.<sup>21</sup>

Finally, Congress could mandate that a truncated version of the SSN (*e.g.*, only the last four digits) be included in the DMF to prevent the theft and misuse of the decedents' identities. Because the release of full SSNs substantially furthers criminal conduct and affects the public fisc, the benefits of partially redacting SSNs may outweigh those of releasing the complete numbers. However, this approach may disclose enough information to permit some amount of identity theft and might be inadequate for pension administrators and other anti-fraud users who rely on full SSNs. Therefore, this approach would require further study.

<sup>19</sup> Identify Theft and Tax Fraud Prevention Act, S. 1534, 112th Cong. § 9(c) (1st Sess. 2011).

<sup>20</sup> See *generally* Internal Revenue Code § 6103.

<sup>21</sup> Typically, decedents have a final tax filing requirement in the year of death. See IRS Publication 559, *Survivors, Executors, and Administrators* 4 (Mar. 2011). A surviving spouse may be able to file as a qualifying widow(er) using the Married Filing Jointly tax rates for two years following the spouse's death. The IRS could retire the SSNs of decedents in the third year after death and thus block any returns with those numbers in later years.

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## 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, in subsections (b) and (g), authorizes the IRS to use its math error authority to summarily assess tax and bypass normal deficiency procedures. From the outset, Congress has made clear that use of math error authority is meant to be limited in scope and should not be used to resolve an uncertainty against the taxpayer.<sup>1</sup>

Originally, math error authority was intended to apply only to simple mathematical and clerical errors.<sup>2</sup> Over the years, however, Congress has expanded its use to a compliance context. The IRS employs it to disallow improper claims where the entry on a tax return conflicts with information from a database or other records.<sup>3</sup> Using math error authority for this additional purpose can be an efficient way to correct inadvertent errors.<sup>4</sup>

Both the Treasury Inspector General for Tax Administration (TIGTA) and the Government Accountability Office (GAO) have recently encouraged the IRS to increase its use of math error authority as a cost-effective way to process certain new items on returns.<sup>5</sup> Although some of the GAO and TIGTA proposals may be appropriate uses of math error authority, it is essential that the IRS conduct a full analysis to ensure that any future expansion of math error authority does not increase taxpayer burden, erode taxpayer rights and protections, and create IRS rework.<sup>6</sup> For taxpayers, this burden could include an IRS adjustment that improperly reduces a refund and delays the release of the correct amount. Additionally, using math error authority for complex, fact-intensive provisions means that math error notices may become more complex. A complex notice could discourage a prompt taxpayer response, which would cause the taxpayer to lose the right to challenge the adjustment in the United States Tax Court (the only forum that does not require the taxpayer to pay the liability before adjudication). For the IRS, additional burden could take the form of increased calls, the need to abate assessments and reprocess returns, and, if the taxpayer

<sup>1</sup> IRC § 6213(g)(2).

<sup>2</sup> H.R. Rep. No. 94-658, 94th Cong., 2d Sess. § 1203, at 291 (Nov. 12, 1975).

<sup>3</sup> IRC § 6213(g)(2). There are now 16 Code provisions giving the IRS the authority to make math error adjustments.

<sup>4</sup> See *Hearing on Improper Payments in the Administration of Refundable Tax Credits Before the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives* 26, 112th Cong. (May 25, 2011) (statement of Nina E. Olson, National Taxpayer Advocate). The National Taxpayer Advocate acknowledges that certain third-party data may appropriately be used in math error adjustments and has previously identified the type of expansions she would consider appropriate. These expansions include the use of the Social Security Administration's (SSA) NUMIDENT database to supply birthdates and Social Security numbers, and the use of IRS internal databases to determine if a taxpayer can claim a credit or has reached a limit (e.g., can an adoption credit be claimed in another year or has a taxpayer reached an applicable monetary limit).

<sup>5</sup> TIGTA, Ref. No. 2011-40-059, *Some Taxpayer Responses to Math Error Adjustments Were Not Worked Timely and Accurately* (July 7, 2011); GAO, GAO 10-349, *Recovery Act; IRS Quickly Implemented Tax Provisions, but Reporting and Enforcement Improvements Are Needed* (Feb. 2010).

<sup>6</sup> See Most Serious Problem: *Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights*, *supra*.

does not contact the IRS within the prescribed 60 days, assigning the case to the Collection function.

Similarly, using math error authority when the information on a taxpayer's return does not match specified third-party information can increase burden and erode taxpayers' rights if the information is not reliable or suitable. Congress has recognized this risk by constraining IRS use of such third-party databases in similar circumstances.<sup>7</sup>

## RECOMMENDATIONS

To ensure that IRS use of math error authority does not impair taxpayers' rights and minimizes burden to both the taxpayer and the IRS, 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):

1. 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 or weigh the adequacy of information.
2. Permit the IRS to use math error authority in conjunction with private third-party databases only where the information has been identified as reliable and accurate, and thus, would not subject the IRS to constraints in litigation.<sup>8</sup>
3. Restrict math error authority in situations with a high abatement rate, where the use of math error authority appears to be unduly burdening compliant taxpayers by requiring them to submit additional documentation within a 60-day timeframe compared to a 90-day timeframe when deficiency procedures are used.

To ensure that future grants of math error authority observe 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 satisfy these criteria. The report should analyze the burdens and benefits of the proposed use of math error authority, considering downstream costs such as those for audit reconsideration and TAS intervention, and rigorously analyze the proposed expansions for accuracy and suitability.

<sup>7</sup> Congress enacted IRC § 6201(d) following the decision in *Portillo v. Comm'r*, 932 F.2d 1128 (5th Cir. 1991). Section 6201(d) places the burden of production in litigation on the Commissioner where the taxpayer raises a reasonable dispute concerning certain information returns supplied by third parties. In *Portillo*, the court found the IRS's determination that the taxpayer had received unreported income of \$24,505 was arbitrary and erroneous, because a Form 1099 sent to the IRS by another taxpayer was the sole basis for the determination. The court concluded that the IRS had a duty to investigate the accuracy of the form and determine if it could be verified by other information, such as the books or records of the taxpayer who submitted it. The court held the IRS did issue a valid deficiency notice, but determined that notice to be arbitrary and erroneous, because the IRS failed to substantiate the charge that the taxpayer had unreported income.

<sup>8</sup> *Portillo v. Comm'r*, 932 F.2d 1128 (5th Cir. 1991).

## EXAMPLE

Under IRC §36(d)(4), to be eligible for the First-Time Homebuyer Credit (FTHBC), a taxpayer must attach a copy of a properly executed settlement statement to the return. IRC § 6213(g)(2)(P) granted the IRS math error authority to deny the credit where the taxpayer failed to attach the statement. Initially, the IRS deemed a settlement statement properly executed if it showed all parties' names and signatures, the property address, sales price, and date of purchase. Normally, Form HUD-1, *Settlement Statement*, would meet these criteria.<sup>9</sup> If the statement omitted this information, the IRS considered it not properly executed, and disallowed the FTHBC using math error authority. As a result, the IRS denied the FTHBC to many taxpayers in states that did not require statements to display all of this information. On finding that complete addresses are not required by all states, the IRS reversed its position, allowed FTHBC claims lacking complete addresses,<sup>10</sup> and now considers settlement statements valid without the buyers' and sellers' signatures.<sup>11</sup> But to make this and other determinations about the sufficiency of the settlement statement, the IRS must review the actual settlement statement, which must be filed with a paper return, thereby eliminating the efficiencies of math error processing and burdening taxpayers. A far better approach for both the IRS and taxpayers would be to limit FTHBC math error authority to determine whether a document that purports to be the settlement statement was actually attached to the return (*i.e.*, a simple yes/no determination), and leave the facts-and-circumstances determination of the *sufficiency* of the settlement statement to normal deficiency procedures.

## PRESENT LAW

### *Status of Math Error Authority*

Sixteen statutory provisions give the IRS the authority to make math error adjustments.<sup>12</sup> Summary assessments made under these provisions can be abated if the taxpayer timely requests abatement.<sup>13</sup> The IRS will then work the case through normal deficiency procedures.<sup>14</sup>

### *Evolution of Math Error Authority*

Upon enactment, IRS math error authority was limited to simple situations with a clear mathematical or clerical error, specifically to "inconsistencies where it can be determined

<sup>9</sup> IRS News Release IR-2010-006, New Homebuyer Credit Form Released; Taxpayers Reminded to Attach Settlement Statements and Other Key Documents (Jan. 15, 2010), <http://www.irs.gov/newsroom/article/0,,id=218336,00.html> (last visited Dec. 27, 2011).

<sup>10</sup> See IRS SERP Alert 100290 (May 25, 2010).

<sup>11</sup> IRM 21.6.3.4.2.11.6 (6) (Servicewide Electronic Research Program (SERP) update Apr. 18, 2011). See also IRS SERP Alert 100066 (Feb. 12, 2010). Mobile home purchasers may submit an executed retail sales contract including the names, address, purchase date, purchase price, and signatures of both taxpayers, if applicable. If the home is newly constructed, a copy of the occupancy permit is sufficient.

<sup>12</sup> IRC § 6213(g)(2)(A) - (P).

<sup>13</sup> IRC § 6213(b)(2)(A).

<sup>14</sup> *Id.*

from the face of the return which inconsistencies are correct.”<sup>15</sup> Further, the mathematical or clerical inconsistencies were to be apparent.<sup>16</sup>

The legislative history elaborated on what Congress considered a mathematical error or inconsistent treatment on a return. “Mathematical” errors include “errors in addition, subtraction, etc.” where “such an error will be apparent and the correct answer will be obvious.”<sup>17</sup> Congress added that the term “inconsistent treatment on a return” was intended to “encompass those cases where it is apparent which of the inconsistent entries is correct and which is incorrect.”<sup>18</sup> Congress also made it clear that the IRS is not to use summary assessment procedures merely to resolve an uncertainty against the taxpayer.<sup>19</sup>

Congress narrowly defined math and clerical error in part so that taxpayers might easily understand what was being adjusted. The following example is based on a scenario taken from the legislative history. It is an example using math error authority to correct a straightforward mistake and shows the level of clarity Congress expected in IRS math error notices.

**Example:** A notice regarding an inconsistency in the number of dependents listed on the taxpayer’s return might read: “You entered six dependents on line x but listed a total of seven dependents on line y. We are using six. If there is one more, please provide corrected information.”<sup>20</sup>

The legislative history also provides specific guidance on what protections are given the taxpayer when the IRS uses summary assessment procedures:

The amendment provides that where the Internal Revenue Service uses the summary assessment procedure for mathematical errors... the taxpayer must be given an explanation of the asserted error... , the taxpayer must be given a period of time during which he or she may require the Service to abate its assessment ... , and the Service is not to proceed to collect on the assessment until the taxpayer has agreed to the assessment or has allowed his or her time for objecting to expire... .<sup>21</sup>

This legislative history illustrates the importance Congress placed on providing taxpayers with notices that adequately explain the adjustments to their returns. However, preserving

<sup>15</sup> IRC § 6213(g)(2)(C).

<sup>16</sup> IRC § 6213(g)(2)(B).

<sup>17</sup> IRC § 6213(g)(2). This provision memorialized what Congress expressed in the legislative history. See also H.R. Rep. No. 94-658, 94th Cong., 2d Sess. § 1203, at 291 (Nov. 12, 1975).

<sup>18</sup> H.R. Rep. No. 94-658, 94th Cong., 2d Sess. § 1203, at 291 (Nov. 12, 1975).

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> S. Rep. No. 938, 94th Cong., 2d Sess. 375 (1976); 1976-3 (Vol. 3) C.B. 49, 413.

this taxpayer protection becomes more difficult as new, complicated provisions fall under math error authority.<sup>22</sup>

### *Authorized Use of Third-Party Data*

In certain situations, the IRS can use third-party data, including information provided by the Social Security Administration (SSA), to identify omitted Taxpayer Identification Numbers (TINs) and make math error adjustments based on that information.<sup>23</sup> The statute also permits the IRS to use the Federal Case Registry of Child Support Orders (FCR) to determine whether a taxpayer is a custodial parent of a child for purposes of the earned income tax credit (EITC).<sup>24</sup> Although the IRS is legally permitted to use this registry, the IRS has refrained from doing so due to concerns raised by the National Taxpayer Advocate about its accuracy, which were later validated by an IRS study.<sup>25</sup>

## REASON FOR CHANGE

As the IRS's resources decrease, it seeks to expand math error authority in new areas as a cost-effective way to protect revenue, particularly where a credit can generate a large refund. This is especially true since the IRS assumes disbursement as well as revenue collection duties and is responsible for preventing large, refundable credits from being improperly issued. Some math error expansions under consideration include the use of third-party data provided by federal agencies other than the SSA, or even outside sources.<sup>26</sup> The National Taxpayer Advocate acknowledges that math error authority can be an appropriate way to stop improper refunds. However, it is crucial, prior to granting expanded authority, that a thorough analysis of the potential impact on taxpayers and the IRS be conducted. Thorough analysis will allow the IRS to avoid inappropriate reliance on databases, such as the FCR. Failing to conduct a thorough review may cause problems similar to those the IRS recently experienced when it inappropriately disallowed the FTHBC through summary assessments, as illustrated in the example above.<sup>27</sup>

<sup>22</sup> IRC § 36. An adjustment to a FTHBC credit is an example of the type of provision that may be challenging to explain clearly in a math error notice.

<sup>23</sup> IRC § 6213(g)(2) provides that a taxpayer shall be treated as having omitted a correct TIN if the information on the return with respect to the individual whose TIN was provided is different from the information the IRS obtains from the SSA.

<sup>24</sup> IRC § 6213(g)(2)(M).

<sup>25</sup> See National Taxpayer Advocate 2002 Annual Report to Congress 189 (Legislative Recommendation: *Math Error Authority*). Congress mandated that the IRS complete a study in conjunction with the National Taxpayer Advocate before implementing the use of the FCR; the study demonstrated that the FCR was unreliable and the IRS did not implement that math error authority. See IRS, *Federal Case Registry Final Report*, Project 5-02-12-3-005 (CR-39) (Sept. 2003); see also *Hearing on Improper Payments in the Administration of Refundable Tax Credits Before the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives* 26, 112th Cong. (May 25, 2011) (statement of Nina E. Olson, National Taxpayer Advocate).

<sup>26</sup> IRS Briefing, Overview of the Accelerated Refund Assurance Program (ARAP) (Oct. 6, 2011).

<sup>27</sup> National Taxpayer Advocate FY 2011 Objectives Report 28 (Filing Season Review).

## EXPLANATION OF RECOMMENDATION

Having the Treasury Department, along with the National Taxpayer Advocate, analyze math error proposals will help identify if the proposal complies with the limitations set out above. This analysis will ultimately determine if summary assessment or deficiency procedures would be more suitable. The GAO previously made a similar recommendation.<sup>28</sup>

### *Facts-and-Circumstances Determinations Should Be Subject to Normal Deficiency Procedures.*

The use of math error authority has become an attractive, cost-effective way to prevent improper refunds from being distributed. However, many of the provisions that generate these refunds have complicated eligibility requirements that vary according to a taxpayer's facts and circumstances. Limiting math error authority in these cases will prevent the types of problems both the IRS and taxpayers experienced with the FTHBC and will stop the IRS from using math error to "resolve an uncertainty against the taxpayer."

### *Notices Would Be Required to Clearly Identify What Is Being Changed, the Reason for the Change, and What Steps the Taxpayer Should Take in Order to Contest the Change.*

Use of math error authority in complex facts-and-circumstances situations makes it more difficult to draft notices that explain clearly what has been changed and why. This lack of clarity may confuse taxpayers, which in turn can delay a refund or result in the taxpayer losing his or her right to dispute the adjustment in the U.S. Tax Court. Therefore, the IRS should be required to demonstrate, prior to receiving math error authority, that it can draft clear notices with respect to that provision.

### *Some Third-Party Information Is Too Unreliable to Use for the Purpose of Math Error.*

Third-party data must be reliable and complete, and meet the standards elsewhere observed by the courts and Congress,<sup>29</sup> if it is used to verify information on a taxpayer's return and make a summary assessment based on that data. The FCR, which the IRS was granted authority by Congress to use to determine whether a taxpayer is a custodial parent of a child for purposes of the earned income tax credit, is an example of an unreliable third-party database, because it was designed for an entirely different purpose. Such reliability concerns also exist for proposals to use certain state databases to determine eligibility, especially with respect to an individual's status as a qualifying child for EITC purposes, which is a complicated determination that requires a determination of the child's residence for more than half the year – a circumstance that may shift from year-to-year and is highly fact-specific. Further, if the information in the database was compiled for a different purpose, the use may not be appropriate, because the data may not disprove eligibility under the tax law. Moreover, the information may be outdated, and it should not deprive a taxpayer of a due

<sup>28</sup> GAO, GAO-11-691T, *Enhanced Prerefund Compliance Checks Could Yield Significant Benefits* (May 25, 2011).

<sup>29</sup> IRC § 6201(d).

process right to present his or her own facts. Such data may not be accurate enough for the IRS to rely on in litigation.<sup>30</sup> Although the database cannot be relied upon when making a summary assessment, it still may be useful as an indicator that the IRS should look more closely at the return in an examination — not math error — context.

*Reliable Data Is Useful in Certain Math Error Situations.*

Use of external data is appropriate for making math error assessments in limited circumstances, namely when the data is reliable and its use will not lead to improper summary assessments. An example of appropriate use of this expanded authority is the use of the Social Security Administration's NUMIDENT database.<sup>31</sup>

It is also appropriate for the IRS to exercise math error authority based on its own internal data (prior-year tax returns), as recommended by GAO in the following two situations.

1. To verify compliance with lifetime limits on amounts that can be claimed, such as for the Residential Energy Credit.<sup>32</sup> This would permit the IRS to verify that the credits claimed for 2009 and 2010 do not exceed the lifetime credit limit of \$1,500.<sup>33</sup>
2. To determine whether a taxpayer exceeded the number of years in which the Hope Scholarship credit can be claimed.<sup>34</sup>

The National Taxpayer Advocate supports these recommendations because the IRS would be using reliable information to make the summary assessments.

<sup>30</sup> *Portillo v. Comm'r*, 932 F.2d 1128 (5th Cir. 1991).

<sup>31</sup> See IRM 2.3.32.8 (July 1, 2008); IRM exhibit 2.3.32-17 (Jan. 1, 2005). NUMIDENT information is a complete history of changes, such as name changes, as reported to SSA by the user of the SSA account number.

<sup>32</sup> GAO, GAO 11-481, *IRS Dealt with Challenges to Date, but Needs Additional Authority to Verify Compliance* (Mar. 2011).

<sup>33</sup> The American Recovery and Reinvestment Act of 2009 limited the aggregate amount of credit for taxable years beginning in 2009 and 2010 to \$1,500. Pub. L. No. 111-5, § 121, 123 Stat. 115, 322 (Feb. 17, 2009) (amending IRC § 25C).

<sup>34</sup> GAO, GAO-11-691T, *Enhanced Prerefund Compliance Checks Could Yield Significant Benefits* (May 25, 2011). The Hope Scholarship Credit under IRC § 25A was modified by the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5. For tax years beginning in 2009 or 2010, the credit was available for the first four years of a student's post-secondary education. See Pub. L. No. 111-5, § 1004(a), 123 Stat. 115, 313 (Feb. 17, 2009). The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the credit to tax years beginning in 2011 and 2012. Pub. L. No. 111-312, § 103, 124 Stat. 3296, 3299 (Dec. 17, 2010).

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## Clarify that the Scope and Standard of Tax Court Determinations Under Internal Revenue Code Section 6015(f) is *De Novo*

### PROBLEM

Married taxpayers who file joint returns are jointly and severally liable for any deficiency or tax due.<sup>1</sup> An “innocent spouse” statute, Internal Revenue Code (IRC) § 6015, provides for relief from deficiencies in the specific circumstances as described in subsections (b) and (c). If relief is unavailable under subsection (b) or (c), a taxpayer may qualify for “equitable” innocent spouse relief from deficiencies and underpayments pursuant to subsection (f).<sup>2</sup> Relief under IRC § 6015(f) is appropriate when, taking into account all the facts and circumstances, it would be inequitable to hold a joint filer liable for the unpaid tax or deficiency. IRS guidance enumerates various factors that should be considered and may weigh in favor of or against granting equitable relief.<sup>3</sup>

The Tax Court, in *Porter v. Commissioner (Porter I)*, held that the *scope* 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.<sup>4</sup> In *Porter v. Commissioner (Porter II)*, the Tax Court held that the *standard* of review in IRC § 6015(f) cases is also *de novo*, meaning that it will consider the case anew, without deference to the agency determination to deny relief.<sup>5</sup> The IRS Office of Chief Counsel disagrees with the Tax Court’s decisions in *Porter I* and *Porter II*. Its position is that the proper standard of review is abuse of discretion, and the scope of the Tax Court’s review is limited to the administrative record.<sup>6</sup> This divergence creates uncertainty for taxpayers and consumes administrative and judicial resources. It is especially harmful to taxpayers who cannot afford representation or assistance during administrative proceedings. Therefore, 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*.

<sup>1</sup> Internal Revenue Code (IRC) § 6013(d)(3); Rev. Proc. 2003-61, 2003-2 C.B. 296.

<sup>2</sup> A deficiency is generally the difference between the amount of tax that should have been shown on the return and the amount that was actually shown. See IRC § 6213. “Underpayment” refers to the tax shown on the return but not paid.

<sup>3</sup> Rev. Proc. 2003-2 C.B. 296, *superseding* Rev. Proc. 2000-15, 2000-1 C.B. 447.

<sup>4</sup> 130 T.C. 115 (2008) (*Porter I*). In *Neal v. Comm’r*, 557 F.3d 1262 (11th Cir. 2009), *aff’g* T.C. Memo. 2005-201, a court of appeals also held that the appropriate scope of Tax Court review in IRC § 6015(f) cases is *de novo*.

<sup>5</sup> 132 T.C. 203 (2009) (*Porter II*). The issue of the appropriate standard of review in IRC § 6015(f) cases is pending in *Wilson v. Comm’r*, T.C. Memo. 2010-134, *appeal docketed*, No.10-72754 (9th Cir. Sept. 10, 2010).

<sup>6</sup> Notice CC-2009-021 (June 30, 2009) states “In all section 6015(f) cases the proper standard of review is abuse of discretion. Attorneys should, therefore, continue to argue that, under an abuse of discretion standard of review, the scope of the Tax Court’s review is limited to issues and evidence presented before Appeals or Examination. Attorneys should raise the scope and standard of review arguments whenever appropriate...noting the Service’s disagreement with the holding in the *Porter* opinions.”

**EXAMPLE**

*Wilson v. Commissioner*<sup>7</sup> illustrates how the Tax Court's independent fact finding and analysis in *de novo* review can produce a different outcome than a decision based only on the administrative record with deference to the IRS's determinations. In that case, Mrs. Wilson's spouse, with whom she filed a joint return, generated additional income by steering people into a Ponzi scheme. Mrs. Wilson was aware of the additional income, which was reported on amended joint returns she signed, but believed it derived from legitimate business operations. Without the assistance of counsel or another representative, she requested equitable relief under IRC § 6015(f) from the underpayment.

Mrs. Wilson was married when she requested equitable innocent spouse relief, a factor that weighs neither for nor against granting relief. The administrative record showed that, among other things, she had made a good faith effort to comply with the tax laws after the years covered by her request for relief, a factor that weighs in favor of granting relief. However, Mrs. Wilson did not substantiate her expenses in support of her claim that she would suffer economic hardship if relief was not granted, and the administrative record contained little information that would establish the size of the tax liability attributable to her husband. Mrs. Wilson did not respond to the IRS's request for an explanation of what she knew when she signed the returns. The IRS, finding that Mrs. Wilson had not shown that she did not know or have reason to know the tax would not be paid, and in view of the other circumstances of the case, denied her request for relief.

Mrs. Wilson petitioned the Tax Court for review, and represented herself ineffectively at a 2005 trial.<sup>8</sup> The Tax Court arranged for *pro bono* counsel and over the IRS's objection, reopened the record and held a second trial in 2008.<sup>9</sup> By the time the Tax Court considered Mrs. Wilson's case in 2008, she was no longer married, which changed the marital status factor to weigh in her favor. Although Mrs. Wilson was not able to prove that she had made a good faith effort to comply with the tax laws in the intervening years, which weighed against granting relief, she introduced evidence about the couple's income and assets during the years at issue, which satisfied the court that she reasonably believed the liability would be paid. The court also accepted Mrs. Wilson's credible testimony about her lifestyle, living expenses, and uncertain financial future at the time of trial and concluded that she would suffer economic hardship if relief were not granted. Based on the evidence in the administrative record and the facts developed at trial, the Tax Court found that the tax liability was attributable entirely to Mr. Wilson. In view of these circumstances and under a *de novo* standard of review, the Tax Court granted Mrs. Wilson's request for equitable relief.

<sup>7</sup> T.C. Memo. 2010-134, *appeal docketed*, No.10-72754 (9th Cir. Sept. 10, 2010).

<sup>8</sup> The Tax Court describes Mrs. Wilson's *pro se* representation as follows: "This excerpt from the transcript of the first trial was typical: 'Call your first witness, then.' 'I have no witnesses.' 'Well, how about yourself?' 'Okay.' 'You count.' 'I count?' 'Yes.'" *Wilson v. Comm'r*, T.C. Memo. 2010-134, 2 n.2.

<sup>9</sup> See Reply Brief for Respondent 3-11, *Wilson v. Comm'r*, T.C. Memo. 2010-134 (No. 23882-04), 2007 WL 7231341.

## RECOMMENDATION

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

## CURRENT LAW

The innocent spouse rules of IRC § 6015 were enacted as part of the Internal Revenue Service Restructuring and Reform Act of 1998.<sup>10</sup> If the IRS denies relief under any subsection of IRC § 6015, the taxpayer may petition the Tax Court.<sup>11</sup> The IRS Office of Chief Counsel maintains that the proper standard of review in all IRC § 6015 cases is abuse of discretion, and that the scope of review is limited to issues and evidence presented before IRS Appeals or Examination.<sup>12</sup>

### Scope of Review

In *Ewing v. Commissioner*, the Tax Court held that the scope of its review in IRC § 6015(f) cases would be *de novo*.<sup>13</sup> The holding was based on the finding that the Administrative Procedure Act, which limits the scope of judicial review to the administrative record, was not applicable to Tax Court proceedings, including IRC § 6015 proceedings.<sup>14</sup> Further, the Tax Court found the use of the word “determine” in IRC § 6015(e) is similar to the use of “redetermination” in IRC § 6213(a), pertaining to deficiencies, under which it is unquestioned that the court conducts trials *de novo*. The Tax Court concluded that the use of this term meant that Congress intended the court to have *de novo* review authority for IRC § 6015(f) cases, even if they do not involve deficiencies.<sup>15</sup>

The *Ewing* case was a stand-alone proceeding: Mrs. Ewing had not requested innocent spouse relief in response to a statutory notice of deficiency but rather in response to the IRS’s determination that she was not entitled to equitable relief. The Tax Court, at an earlier stage of the proceedings, had already considered the question of whether it had jurisdiction to review Mrs. Ewing’s petition, and found that it did.<sup>16</sup> However, on appeal,

<sup>10</sup> Pub. L. No. 105-206, sec. 3201(a), (b), 112 Stat. 685 at 734, 739 (1998).

<sup>11</sup> In addition to the Tax Court’s jurisdiction to redetermine deficiencies under IRC § 6213, IRC § 6015(e) provides that the Tax Court has jurisdiction to determine the appropriate relief available under IRC § 6015 if the petition is filed in response to the IRS’s final determination or after the claim for innocent spouse relief has been pending with the IRS for six months and no final determination has been issued. The filing of a Tax Court petition where jurisdiction is predicated on IRC § 6015(e) and not on deficiency jurisdiction under IRC § 6213 is often referred to as a stand-alone proceeding.

<sup>12</sup> Notice CC-2009-021 (June 30, 2009).

<sup>13</sup> 122 T.C. 32 (2004), *vacated on other grounds sub nom. Comm’r v. Ewing*, 439 F.3d 1009 (9th Cir. 2006).

<sup>14</sup> 122 T.C. at 35, 37-38 (citing 5 U.S.C. §§ 551-559, 701-706 (2000)).

<sup>15</sup> The Tax Court also noted that some proceedings in IRC § 6015(f) cases could not be based on the administrative record. For example, if a taxpayer petitions the Tax Court after the request for relief has been pending for six months, as permitted by IRC § 6015(e)(1)(A)(i)(II), there may be no administrative record. As another example, a taxpayer may, in a deficiency proceeding, raise IRC § 6015(f) as an affirmative defense. Again, there would be no administrative record to consult, and the scope of review would be *de novo*. The Tax Court deemed it anomalous to use different standards to decide the same issue simply because of differences in the procedural posture in which the issue was brought before the court. Moreover, Congress provided for intervention by nonrequesting spouses, which suggests it intended trials *de novo* under IRC § 6015(f) to permit the other spouse to offer evidence.

<sup>16</sup> *Ewing v. Comm’r*, 118 T.C. 494 (2002), *rev’d. sub nom. Comm’r v. Ewing*, 439 F.3d 1009 (9th Cir. 2006).

the Ninth Circuit Court of Appeals found that the Tax Court lacked jurisdiction over stand-alone cases under IRC § 6015(f).<sup>17</sup> It therefore reversed the Tax Court's earlier decision that it had jurisdiction over the claim, and vacated the Tax Court's decision pertaining to scope of review.<sup>18</sup> Congress then amended IRC § 6015(e) to make explicit that the Tax Court does have jurisdiction in stand-alone IRC § 6015(f) cases.<sup>19</sup>

The issue of scope of review again arose in *Porter I*, and the Tax Court, drawing heavily on its reasoning in *Ewing*, again held that the appropriate scope of review is *de novo*.<sup>20</sup> The IRS did not appeal the Tax Court's decision in *Porter I*, and the court continued to hold that the proper scope of review was *de novo*.<sup>21</sup> When the IRS appealed one such decision, *Neal v. Commissioner*, the Eleventh Circuit Court of Appeals affirmed the Tax Court's holding that its scope of review is *de novo*.<sup>22</sup>

The IRS maintains that *de novo* review of IRC § 6015(f) cases is not appropriate.<sup>23</sup> It analogizes IRC § 6015(f) proceedings to collection due process determinations under IRC § 6330.<sup>24</sup> The IRS has successfully established in two courts of appeal that Tax Court

<sup>17</sup> The Ninth Circuit found that because the IRS never determined a deficiency against Mrs. Ewing and her husband, the Tax Court lacked jurisdiction. At the time of this appellate court decision, IRC § 6015(e), the provision authorizing Tax Court review of innocent spouse cases, provided "In the case of an individual *against whom a deficiency has been asserted* and who elects to have subsection (b) or (c) apply-

(A) In general.-In addition to any other remedy provided by law, the individual may petition the Tax Court (and the Tax Court shall have jurisdiction) to determine the appropriate relief available to the individual under this section..." (emphasis added);

See also *Bartman v. Comm'r*, 446 F.3d 785, 787 (8th Cir. 2006), *affg. in part and vacating in part* T.C. Memo. 2004-93, and *Billings v. Comm'r*, 127 T.C. 7 (2006) (holding that the Tax Court lacked jurisdiction over stand-alone IRC § 6015(f) claims).

<sup>18</sup> *Comm'r v. Ewing*, 439 F.3d 1009 (9th Cir. 2006).

<sup>19</sup> The Tax Relief and Health Care Act of 2006 (TRHCA), Pub. L. No. 109-432, Div. C, § 408(a), (c), 120 Stat. 2922, 3061-62 (2006), amended IRC § 6015(e) to expressly provide that the Tax Court has jurisdiction to review stand-alone cases under IRC § 6015(f), even where no deficiency has been asserted. IRC § 6015(e) now provides "In the case of an individual against whom a deficiency has been asserted and who elects to have subsection (b) or (c) apply, or in the case of an individual who requests equitable relief under subsection (f)--

(A) In general. -In addition to any other remedy provided by law, the individual may petition the Tax Court (and the Tax Court shall have jurisdiction) to determine the appropriate relief available to the individual under this section..." (emphasis added).

The National Taxpayer Advocate intended to recommend in her 2006 Annual Report to Congress that Congress amend IRC § 6015(f) to provide such jurisdiction, but did not do so because a bill, H.R. 6111, which became TRHCA, had passed both houses of Congress and was signed by the President on Dec. 6, 2006. National Taxpayer Advocate 2006 Annual Report to Congress 535. In *Billings v. Comm'r*, T.C. Memo. 2007-234 the Tax Court held that it had jurisdiction to consider the case it had previously dismissed for lack of jurisdiction in *Billings v. Comm'r*, 127 T.C. 7 (2006).

<sup>20</sup> 130 T.C. 115 (2008).

<sup>21</sup> The Tax Court's decision in *Porter I* was in response to the IRS's motion *in limine* (i.e., as a preliminary matter) to preclude the taxpayer from introducing evidence not contained in the administrative record.

<sup>22</sup> *Neal v. Comm'r*, T.C. Memo. 2005-201, *aff'd sub nom. Comm'r v. Neal*, 557 F.3d 1262 (11th Cir. 2009).

<sup>23</sup> Notice CC-2009-021 (June 30, 2009).

<sup>24</sup> See Opening Brief for Respondent at 15, *Wilson v. Comm'r*, T.C. Memo. 2010-134 (No. 23882-04), 2005 WL 6503242; *Haigh v. Comm'r*, T.C. Memo. 2009-140, slip op. at 14 n.25; *Beatty v. Comm'r*, T.C. Memo. 2007-167, slip op. at 19 n.3. The government makes the same argument to the appellate court in *Wilson*, *supra*. See Brief for the Appellant at 55-59, *Wilson v. Comm'r*, No. 10-72754 (9th Cir. Jan. 19, 2011). IRC § 6330 provides for notice and opportunity for a collection due process hearing before the IRS may levy upon the property of any person. At the hearing, the person may raise any relevant issue relating to the unpaid tax or proposed levy, including spousal defenses, challenges to the appropriateness of the collection action, and offers of collection alternatives. IRC § 6330(c)(2)(A). The person may challenge the existence or amount of the underlying tax liability for any period only if the person did not receive a notice of deficiency or did not otherwise have an opportunity to dispute the liability. IRC § 6330(c)(2)(B). Once the IRS issues a notice of determination, the person may petition the Tax Court. IRC § 6330(d)(1). As contemplated in the legislative history of IRC § 6330, see H.R. Conf. Rept. No. 105-599 at 266 (1998), if the validity of the underlying tax liability is at issue, the Tax Court standard of review for that issue is *de novo*. Other issues are reviewed for an abuse of discretion, described *infra*. *Sego v. Comm'r*, 114 T.C. 604, 610 (2000).

review in collection due process cases under IRC § 6330, where the underlying liability is not at issue, is confined to the administrative record.<sup>25</sup> The Tax Court continues to reject the IRS's position that review under IRC § 6015(f) is limited to the administrative record and rejects the analogy to proceedings under IRC § 6330.<sup>26</sup>

### Standard of Review

"The *scope* of judicial review refers...to the *evidence* the reviewing court will examine in reviewing an agency decision. The *standard* of judicial review refers to *how* the reviewing court will examine that evidence."<sup>27</sup> Under a *de novo* standard of review, the court considers the facts of the case anew and determines whether it is inequitable to hold the requesting spouse liable for the unpaid tax or deficiency. 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, and the requesting spouse bears the burden of proving that the Commissioner abused his discretion in denying relief.<sup>28</sup>

In *Porter v. Commissioner (Porter II)*, the Tax Court considered the language of IRC § 6015, which provides, under subsections (b) and (c), that the taxpayer "elects" relief, and if she or he meets the statutory requirements, "shall" be relieved of liability for the deficiency. Subsection (f), by contrast, provides that the IRS "may," pursuant to procedures it prescribes, relieve an individual of liability for any unpaid tax or deficiency stemming from a joint return when, in consideration of all the facts and circumstances, it would be inequitable to hold the individual liable. The court noted that it had previously reviewed IRC § 6015(f) cases for an abuse of discretion. However, the court decided, "Given Congress's confirmation of our jurisdiction [in stand-alone IRC § 6015(f) cases], reconsideration of the standard of review in section 6015(f) cases is warranted."<sup>29</sup> The Tax Court held that from then on it would review IRS denials of relief under IRC § 6015(f) using a *de novo* standard, rather than the abuse of discretion standard of review it had previously used. The Tax Court noted that it had always reviewed claims for relief under IRC § 6015(b) and (c) *de*

<sup>25</sup> *Robinette v. Comm'r*, 439 F.3d 455 (8th Cir. 2006), *rev'g* 123 T.C. 85 (2004); *Murphy v. Comm'r*, 469 F.3d 27 (1st Cir. 2006), *affg* 125 T.C. 301 (2005).

<sup>26</sup> See, e.g., *Torrisi v. Comm'r*, T.C. Memo. 2011-235, slip op. at 17 n.15 (acknowledging the IRS's disagreement with *Porter II* and the court's use of *de novo* standard and scope of review in equitable innocent spouse relief cases, but declining to revisit the issue). The Tax Court generally reviews IRC § 6330 cases *de novo*, except in cases appealable to courts of appeal that have held otherwise. Pursuant to the rule in *Golsen v. Comm'r*, 54 T.C. 742, 757 (1970), *aff'd* 445 F.2d 985 (10th Cir. 1971), the Tax Court will defer to a Court of Appeals decision which is squarely on point where appeal from the Tax Court decision lies to that Court of Appeal. See *Olson v. Comm'r*, T.C. Memo. 2009-294, slip op. at 3-4; *Bruen v. Comm'r*, T.C. Memo. 2009-249, slip op. at 5 ("The CDP [collection due process] petitioner's agency-level remedies are described at some length in section 6330(a), (b), and (c), and section 6330(d)(2) provides that the CDP petitioner must first 'exhaust [ ] all administrative remedies' before coming to court; but section 6015 makes no explicit provision of agency-level remedies for innocent spouse relief and says nothing about exhausting them. The agency's CDP action is repeatedly characterized in section 6330 as a 'hearing,' but there is no agency hearing explicitly provided for the innocent spouse in section 6015. The taxpayer's CDP submission to the Tax Court under section 6330(d) is called an 'appeal' and is not referred to as a 'petition' anywhere in the statute, while section 6015(e) provides that the innocent spouse files a 'petition' that is nowhere called an 'appeal.' The Tax Court 'determine[s]' innocent spouse relief, sec. 6015(e)(1)(A), but simply has 'jurisdiction' over the agency's CDP determination, sec. 6330(d)(1).") (footnote ref. omitted).

<sup>27</sup> *Franklin Sav. Association v. Office of Thrift Supervision*, 934 F.2d 1127, 1136 (10th Cir.1991) (emphasis added).

<sup>28</sup> *Jonson v. Comm'r*, 118 T.C. 106, 125 (2002), *aff'd* 353 F.3d 1181 (10th Cir. 2003).

<sup>29</sup> 132 T.C. 203, 208 (2009); *Porter II* is a continuation of the same case that produced the 2008 holding (*Porter I*, discussed above) that Tax Court review of denials of relief under IRC § 6015(f) is not limited to the administrative record.

*novo*, and in view of the statutory direction that the Tax Court determine the appropriate relief available under subsections (b), (c), and (f), there was no longer any reason to apply a different standard of review under subsection (f) than under subsections (b) and (c).

## REASONS FOR CHANGE

The IRS position is that in all section 6015(f) cases, the proper standard of review is abuse of discretion and the scope of the Tax Court's review is limited to issues and evidence presented before Appeals or Examination. IRS attorneys are instructed to raise the scope and standard of review arguments whenever appropriate, noting the IRS's disagreement with the holding in the *Porter* opinions.<sup>30</sup> The Tax Court continues to follow its own precedent, employing the *de novo* standard and scope of review. One case with the issues of the proper scope and standard of review is pending on appeal.<sup>31</sup> The resulting uncertainty is a burden on taxpayers and consumes administrative and judicial resources. Moreover, the IRS's position would create particular difficulty for taxpayers who are victims of domestic violence or abuse. The recent *Stephenson* case is a good example of this dynamic.<sup>32</sup>

The Tax Court's finding that Mrs. Stephenson was physically and verbally abused by her husband was largely based on evidence produced at trial because the issue of abuse was not fully developed administratively.<sup>33</sup> The court relied on Mrs. Stephenson's testimony, which fleshed out the details of her abuse, and the corroborating testimony from a third-party witness. If the Tax Court had confined itself to the administrative record, it might not have found Mrs. Stephenson had been abused, which might have resulted in denying her relief.

Because victims of abuse may be more comfortable providing details of their abuse to a neutral third party — the judge — during a trial, rather than to the IRS during the administrative process, and for the other reasons given by the Tax Court, the National Taxpayer Advocate agrees that *de novo* review, not confined to the administrative record, is appropriate.

## EXPLANATION OF RECOMMENDATION

Amending IRC § 6015 to specify that the Tax Court scope and standard of review of IRC § 6015(f) cases is *de novo* would clarify that the Tax Court's review of denials of relief under IRC § 6015(f) is not limited to the administrative record, and the Tax Court reviews IRC § 6015(f) cases anew, without deference to the IRS's determination. This clarification would be consistent with Congress' intent in amending IRC § 6015(e) to specify that the Tax Court has jurisdiction in stand-alone innocent spouse cases, would codify the Tax Court's interpretation of the statute, and would avert a potential conflict among the Courts of Appeals.

<sup>30</sup> Notice CC-2009-021 (June 30, 2009).

<sup>31</sup> *Wilson v. Comm'r*, T.C. Memo. 2010-134, *appeal docketed*, No.10-72754 (9th Cir. Sept. 10, 2010).

<sup>32</sup> *Stephenson v. Comm'r*, T.C. Memo. 2011-16.

<sup>33</sup> See Most Serious Problem: *The IRS Does Not Sufficiently Recognize and Address Domestic Violence and Abuse and its Effects on Tax Administration*, *supra* (describing the need for better training in this area and the IRS's resistance to eliciting information about abuse).

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## 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 Section 6343(a) relieve individuals, but not businesses, from levies on the grounds of economic hardship.<sup>1</sup> In one area of collections activity, the IRS and Department of Treasury have expressly declined to take into account business economic hardship, citing concern that the government might thereby be forgoing the collection of taxes to support a nonviable business.<sup>2</sup> Thus, the IRS will not release levies when a business experiences an economic hardship, leading the IRS to use levies in lieu of collection alternatives.

Since the recession of 2008,<sup>3</sup> the IRS has increased its use of levies against businesses. In fiscal year (FY) 2011, the IRS collected \$702 million from its Business Master File (BMF) levies, an increase of 20 percent over FY 2008.<sup>4</sup> While the IRS Collection Field function (CFf) issued 822,757 levies, an increase of 120 percent from FY 2008,<sup>5</sup> the IRS accepted few collection alternatives. The IRS granted only 850 BMF offers in compromise (OICs) and 105,786 BMF installment agreements (IAs) in FY 2011.<sup>6</sup> Unlike collection alternatives, IRS levies may immediately force business liquidations, which may cause economic hardship to the business owners, their customers, and their employees, some of whom may be forced to seek public assistance. Moreover, in determining whether to levy against a business taxpayer's property, the IRS does not consider the working capital needs of a business to maintain operations and avoid liquidation.<sup>7</sup>

According to the regulations, the IRS is required to release levies against individual taxpayers, including sole proprietorships, if the levy will cause the individual an economic hardship (*i.e.*, the individual is unable to meet basic living expenses).<sup>8</sup> Further, the regulations provide that the IRS can enter into an effective tax administration OIC with an individual where the IRS could collect the liability in full but collection would create an economic hardship.<sup>9</sup> The IRS also may forgo collection of an individual taxpayer's account and place

<sup>1</sup> IRC § 6343(a)(1)(D); Treas. Reg. § 301.6343-1(b)(4) (eff. Dec. 30, 1994).

<sup>2</sup> Compromise of Tax Liabilities, 67 Fed. Reg. 48,025, 48,026 (July 23, 2002) (preamble).

<sup>3</sup> See CNN Money, *It's official: Recession since Dec. '07* (Dec. 1, 2008), <http://money.cnn.com/2008/12/01/news/economy/recession/index.htm>.

<sup>4</sup> IRS, Collection Activity Report NO-5000-23, *Collection Workload Indicators* (Oct. 2011).

<sup>5</sup> *Id.* The IRS collected \$585 million from its Business Master File (BMF) levies in FY 2008. The IRS Collection Field function (CFf) issued 374,028 levies in FY 2008. The CFf primarily collects from small businesses and self-employed individuals. The IRS does not specifically track or have a code in its integrated data retrieval system (IDRS) to show that a BMF levy has been made. The IRS classified 694,036 BMF taxpayers in taxpayer delinquent account (TDA) status (active collection inventory) for FY 2011. IRS, Collection Activity Report NO-5000-2, *TDA Cumulative Report* (Oct. 2011).

<sup>6</sup> IRS CDW, Business Master File (BMF) Transaction History Table, extract cycles between 201040-201139 for TC 971, Action Code (AC) 32 (fully accepted OIC). IRS, Collection Activity Report NO-5000-6, *Installment Agreement Report* (Oct. 2011).

<sup>7</sup> The IRS generally takes funds held by third parties (e.g., bank deposits) first. Internal Revenue Manual (IRM) 5.11.1.1.2(2), Notice of Levy vs. Seizure (Jan. 19, 1999). See also IRM 5.11.1.2.4(3) (Dec. 11, 2009) (discussing whether levy is appropriate).

<sup>8</sup> IRC § 6343(a)(1)(D); Treas. Reg. § 301.6343-1(b)(4).

<sup>9</sup> Treas. Reg. § 301.7122-1(b)(3), providing that economic hardship is defined by Treas. Reg. § 301.6343-1(b)(4); IRM 5.8.11.2.1 (Sept. 23, 2008).

it into currently not collectible (CNC) status if collection would create an economic hardship.<sup>10</sup> Under longstanding regulations, however, the IRS and Treasury have determined not to consider economic hardship or effective tax administration when applying collection alternatives or taking levy action against businesses.

### EXAMPLE

A business with 50 employees builds prefabricated homes for sale primarily in and around Las Vegas, Nevada. Due to a sudden economic downturn in that region, particularly in the housing market, the taxpayer falls behind on one quarter of its payroll taxes and owes \$30,000. The firm also has difficulty paying some of its suppliers, and several units it manufactured have not shipped due to its customers' financial difficulties. The taxpayer responds by freezing salaries, eliminating overtime, laying off employees, and discounting the units in its inventory for quick sale. Further, the taxpayer negotiates promissory notes payable to its suppliers to maintain its supply of raw materials until it can pay the notes when business volume increases. Two quarters later, a revenue officer (RO) contacts the taxpayer and requests full payment of \$30,000, plus interest and penalties. The business has consistently filed tax returns over its history and all of its deposits are current since the delinquent quarter. However, the taxpayer does not qualify for an installment agreement to full pay the delinquent quarter in 60 months because the taxpayer is barely earning enough to pay its operating expenses, purchase raw materials, make payroll, and pay its current tax obligations. The RO evaluates the taxpayer's assets, determines there is sufficient equity in assets, and decides that levying on the taxpayer's bank account, with a balance of \$45,000, would adequately pay the debt. However, levying will cause an economic hardship because it will force the taxpayer to stop paying either its operating expenses or payroll tax deposits.

The RO is not permitted to take into account the business's working capital needs or the economic hardship a levy would create for the business and its employees and customers. When the RO issues the levy, it causes significant business disruption to the taxpayer and results in two more employees being laid off.

### RECOMMENDATION

The National Taxpayer Advocate recommends that Congress amend IRC § 6343(a)(1)(D) to:

- Permit the IRS, in its discretion, to release a levy against the taxpayer's property or rights to property if the IRS determines that the satisfaction of the levy is creating an economic hardship due to the financial condition of the taxpayer's business; and
- Require the IRS, in making the determination to release a levy against a business on economic hardship grounds, to consider the economic viability of the business, the

<sup>10</sup> IRM 5.16.1.1 (Apr. 29, 2011). IRM 5.15.1.1(6) (Oct. 2, 2009) refers employees to Treas. Reg. § 301.6343-1(b)(4) in analyzing a taxpayer's financial condition.

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, as well as whether the taxes could be collected from a responsible person under an IRC § 6672 Trust Fund Recovery Penalty (TFRP) assessment.<sup>11</sup>

## PRESENT LAW

After the IRS gives notice and demands payment of a tax liability, provides notice of the taxpayer's right to a Collection Due Process hearing, and gives the taxpayer at least 30 days notice before levying, the IRS can generally collect any tax by levy upon all of the taxpayer's property and rights to property.<sup>12</sup> The Taxpayer Bill of Rights I (TBOR I), enacted in 1988, requires that the IRS release any levy upon a taxpayer's property or rights to property if the IRS determines the levy is creating an economic hardship due to the financial condition of the taxpayer.<sup>13</sup>

Congress gave the Secretary of the Treasury a specific grant to prescribe regulations implementing levy release.<sup>14</sup> The IRS regulations regarding levy release for economic hardship state:

The levy is creating an economic hardship due to the financial condition of an individual taxpayer. This condition applies if satisfaction of the levy in whole or in part will cause an individual taxpayer to be unable to pay his or her reasonable basic living expenses. The determination of a reasonable amount for basic living expenses will be made by the director and will vary according to the unique circumstances of the individual taxpayer. Unique circumstances, however, do not include the maintenance of an affluent or luxurious standard of living.<sup>15</sup>

In its procedures, the IRS reasons, "Because economic hardship is defined as the inability to meet reasonable basic living expenses, it applies only to individuals (including sole proprietorship entities). Compromise on economic hardship grounds is not available to corporations, partnerships, or other non-individual entities."<sup>16</sup>

<sup>11</sup> IRC § 6672 provides that any person required to collect, truthfully account for, and pay over any tax imposed under the Code who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall be liable for a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over. The penalty is also known as the Trust Fund Recovery Penalty (TFRP).

<sup>12</sup> IRC § 6331(a),(d). IRC § 6330 provides that the IRS may not issue a levy before providing a Collection Due Process (CDP) hearing notice, nor during any requested hearing, unless the collection of the tax is in jeopardy, or the levy is upon a taxpayer's state tax refund, is a federal contractor levy, or is a disqualified employment tax levy. Any levy to collect employment taxes is a disqualified employment tax levy if the taxpayer requested a CDP hearing with respect to employment taxes arising in the most recent two-year period before the beginning of the taxable period with respect to which the levy is served. IRC § 6330(h)(1).

<sup>13</sup> This section of Taxpayer Bill of Rights I was enacted as part of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), Pub. L. No. 100-647, § 6236(f), 102 Stat. 3740 (codified as IRC § 6343(a)).

<sup>14</sup> IRC § 6343(a) provides for "Regulations prescribed by the Secretary."

<sup>15</sup> Treas. Reg. § 301.6343-1(b)(4)(i).

<sup>16</sup> IRM 5.8.11.2.1(2) (Sept. 23, 2008) (emphasis in original).

In developing the regulations for effective tax administration offers in compromise (ETA OICs), the IRS and Treasury considered taking business economic hardship into account but did not develop a standard for doing so.<sup>17</sup> They ultimately concluded that granting ETA OICs on the grounds of business economic hardship did not necessarily promote effective tax administration because permitting compromise where there is no doubt as to collectibility might raise the issue of “whether the government should be forgoing collection of taxes to support a nonviable business.”<sup>18</sup>

## REASONS FOR CHANGE

The IRS should generally reserve levy actions for situations where a taxpayer is unwilling to cooperate or comply.<sup>19</sup> If the IRS releases levies for business economic hardship, the IRS and taxpayers may work toward collection alternatives giving businesses a second chance when facing economic hardship. Treasury regulations and IRS procedures are restrictive in allowing businesses access to collection alternatives to settle their tax debts. Further, IRS enforcement actions may lead to noncompliance if they are so harsh as to force the taxpayer into the cash economy.<sup>20</sup>

Currently, the use of flexible payment alternatives by the IRS to resolve business-related tax debts is negligible. At the end of FY 2011, the IRS’s inventories of active balance due and active collection cases held 5.3 million BMF taxpayers.<sup>21</sup> Yet, in FY 2011, the IRS accepted only 850 BMF OICs, which is less than one-tenth of one percent of its active inventory, and 105,786 BMF IAs, which is two percent of its active inventory.<sup>22</sup> Greater flexibility in considering collection and payment alternatives, as opposed to enforced collection, may enable cooperative businesses to remain in compliance with current payment requirements.

Before seizing business assets, the IRS considers alternative methods of collection, including bank or wage levies, IAs, or OICs, but will not use a collection alternative that places greater collection risk on the government.<sup>23</sup> The IRS’s risk analysis does not consider market conditions, supplier or customer problems, or other factors causing economic hard-

<sup>17</sup> Compromise of Tax Liabilities, 67 Fed. Reg. 48,025, 48,026 (July 23, 2002) (preamble).

<sup>18</sup> Treas. Reg. § 301.7122-1(b)(3); Compromise of Tax Liabilities, 67 Fed. Reg. 48,025, 48,026 (July 23, 2002) (preamble). The IRS and Treasury further reasoned that IRS experience has shown that the doubt as to collectibility standard for evaluating offers may permit the resolution of cases involving businesses. In addition, they reasoned if compromise was unavailable on collectibility grounds, compelling public policy or equity considerations under the effective tax administration standard may provide sufficient grounds to compromise.

<sup>19</sup> See Most Serious Problem: *The IRS Does Not Emphasize the Importance of Personal Taxpayer Contact as an Effective Tax Collection Tool*, *supra*.

<sup>20</sup> National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 75-77 (*Researching the Causes of Noncompliance: an Overview of Upcoming Studies*). Small businesses that receive income not subject to information reporting in a cash economy may be responsible for the largest portion of the tax gap. IRS, Tax Gap Map for Year 2001 (Feb. 2007).

<sup>21</sup> IRS, Compliance Data Warehouse (CDW), BMF Status History Table and Transaction History Table, extract cycles between 201040-201139 for Status Code 21 (balance due), Status Code 22 (Automated Collection System (ACS)), Status Code 26 (CFf), Status Code 58 (final balance due notice), and Status Code 71 (offer in compromise (OIC) pending), including unreversed Transaction Codes (TCs) 480 and 780 (OIC pending or in suspense).

<sup>22</sup> IRS CDW, Business Master File (BMF) Transaction History Table, extract cycles between 201040-201139 for TC 971, Action Code (AC) 32 (fully accepted OIC). IRS, Collection Activity Report NO-5000-6, *Installment Agreement Report* (Oct. 2011).

<sup>23</sup> IRM 5.10.1.3.2 (Oct. 13, 2005).

ship when weighing seizure of a business's assets such as raw materials or equipment. For example, revenue officers compare the business's prior year gross receipts against current receipts to project future income.<sup>24</sup> This comparison does not necessarily reflect future market or economic conditions. Further, the IRS fails to consider the working capital needs of a business to maintain operations and avoid liquidation.<sup>25</sup>

Guided by Treasury regulations, 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.<sup>26</sup> IRS collection procedures do not call for consideration of factors such as the years the entity has been in business, the business's long-term compliance history, or the nature of the delinquency problem in the analysis of enforced collection action. A better analysis would also consider whether the tax problems are related to abrupt, temporary changes in market conditions (in terms of the nation, geographic region, and specific industry or sector), supplier problems, credit supply, or whether the taxpayer has a history of poor business decisions.

The IRS should not be an unwilling partner in a business venture,<sup>27</sup> but also should not cause the failure of a viable business that is exercising ordinary business care and prudence. In the context of whether a business taxpayer exercised ordinary business care and prudence in failing to pay employment taxes, the Tax Court weighs several factors including the taxpayer's (1) favoring other creditors over the government, (2) past history of deposit noncompliance, (3) financial decisions, and (4) willingness to decrease expenses and personnel.<sup>28</sup> Although the IRS considers some of these factors in its collection analysis, the IRS does not consider whether the taxpayer exercised ordinary business care and prudence in its decisions when evaluating collection alternatives or whether to take levy action. The IRS and Treasury established regulations interpreting economic hardship during economic prosperity. Given current economic conditions, Congress should provide additional relief by permitting the government to forgo the collection of tax by levy after the IRS makes certain determinations about how a levy will affect a business.

<sup>24</sup> IRM 5.15.1.14(2) (Oct. 2, 2009).

<sup>25</sup> The IRS generally takes funds held by third parties (e.g., bank deposits) first. IRM 5.11.1.1.2(2), Notice of Levy vs. Seizure (Jan. 19, 1999). See also IRM 5.11.1.2.4(3) (Dec. 11, 2009), discussing whether levy is appropriate.

<sup>26</sup> IRM 5.14.2.1 (Mar. 11, 2011). IRM 5.8.5.4 (Oct. 22, 2010). IRM 5.15.1.12, *Business Entities* (Oct. 2, 2009) provides that using the income statement, a taxpayer or revenue officer can quickly figure cash flow, and how the business is doing, but the procedure does not explain what to do if cash flow has decreased or is impaired. IRM 5.15.1.14(2) (Oct. 2, 2009) provides that comparing a business's prior year's gross receipts versus current year's gross receipts gives revenue officers a "good idea" of cash flow, but does not explain how impairment of cash flow should be handled. IRM 5.15.1.34(3), *Cash Flow Analysis* (May 9, 2008) provides that cash flow is the best measure of a company's profits, but the IRM section does not explain why or how this should be adjusted if a business is suffering an economic crisis.

<sup>27</sup> See, e.g., *Brewery, Inc. v. U.S.*, 33 F.3d 589, 593 (6th Cir. 1994) holding that a business's sound judgment to divert trust fund taxes to pay wages and suppliers was not reasonable cause for failing to pay taxes but rather constituted willful neglect. The court further observed that failure to remit trust fund taxes cannot properly be excused on the grounds that the business has used the funds to pay other creditors, as the government would thereby be made an unwilling partner in a floundering concern.

<sup>28</sup> *Custom Stairs & Trim, Ltd. v. Comm'r*, T.C. Memo. 2011-155, slip op. at 18-19.

## EXPLANATION OF RECOMMENDATION

The National Taxpayer Advocate recommends that IRC § 6343 be amended to authorize the IRS to release a levy if it determines that the levy is creating an economic hardship due to the financial condition of the taxpayer's viable trade or business. The legislation should require the IRS, in determining whether to release a levy for economic hardship, to consider all the facts and circumstances of the taxpayer's financial situation, including the business's viability and its expenditures in light of its income. By making the release of the levy discretionary for businesses but retaining the mandatory release for individuals experiencing economic hardship, the recommendation acknowledges the government's concern to not become an "unwilling partner" in a business venture.

### **The IRS must first determine the viability of a business.**

In deciding whether to release a levy, the IRS must determine whether the business is a going concern that is actively engaged in business with the expectation of doing so indefinitely. The business should be able to demonstrate its projected continued operation for a reasonable period and should provide evidence of positive cash flow (*i.e.*, cash receipts sufficient to cover cash expenditures for a specific period), or a plan to achieve the same.<sup>29</sup> Earning income sufficient to fund minimum working capital, pay current business operating expenses, and pay current taxes should support a finding that the business is viable. Further, a taxpayer's reasonable plan to overcome current income shortfalls by adjusting expenses or eliminating nonessential expenses, or by implementing new activities that will generate additional income after expenses, should weigh in favor of business viability.

### **After determining whether a business is viable, the IRS should employ several factors to determine business economic hardship.**

A finding of business economic hardship should include a review of the change in a business's financial condition such as declining sales, the death or disability of a key officer or employee, frozen credit lines, a reduction in working capital, difficulty meeting expenses or making loan payments, as well as whether the taxpayer exercised ordinary business care and prudence in its decisions.<sup>30</sup> The IRS should require the taxpayer to demonstrate that it is experiencing an economic hardship, identify its nature, and provide evidence to confirm it exists.

<sup>29</sup> See, *e.g.*, Small Business Administration (SBA), Office of the Inspector General, Report No. ROM 11-03, *America's Recovery Capital (ARC) Loans Were Not Originated and Closed in Accordance with SBA's Policies and Procedures* 5 (Mar. 2, 2011), which describes the standards used in the ARC Loan Program. The SBA created the ARC Loan Program pursuant to the American Recovery and Reinvestment Act of 2009 to provide deferred-payment, interest-free loans of up to \$35,000 to "viable small businesses" experiencing "immediate financial hardship." The SBA designed the program, which expired on September 30, 2010, to help businesses make principal and interest payments on qualifying small business loans. Under the ARC loan program, the SBA required businesses to demonstrate continued operation for a reasonable period by providing quarterly cash flow projections for up to two years.

<sup>30</sup> SBA Office of the Inspector General, Report No. ROM 11-03, *America's Recovery Capital (ARC) Loans Were Not Originated and Closed in Accordance with SBA's Policies and Procedures* 2 (Mar. 2, 2011). Immediate financial hardship is demonstrated by a change in the financial condition of a small business such as a 20 percent or more decline in revenue over the preceding 12 months, a 20 percent or more increase in expenses over the preceding 12 months, or a 20 percent or more reduction in working capital, and so forth.

As with individuals, the maintenance of the business owner's affluent or luxurious standard of living should weigh against the IRS determining economic hardship.<sup>31</sup> A history of past compliance should weigh in favor of a determination of economic hardship. Business revenue loss due to a permanent impairment on a business without a corresponding reduction in employees, bonuses, salaries, or other expenses should weigh against a finding of economic hardship, unless the revenue loss is due to a problem such as a natural disaster.

Unlike an individual in economic hardship, a business does not have basic living expenses *per se*, but will have business-related expenses that are necessary for continued operation. Additionally, most businesses have related parties (employees, customers, contractors, owners) who could suffer an economic hardship if the levy is satisfied, particularly if the IRS enforcement action will likely lead to the failure of the business. As the number of affected persons increases, a determination of economic hardship might become more compelling. The IRS should also evaluate any other factor or special circumstance raised by the taxpayer that is causing hardship before the IRS determines business economic hardship. Further, the IRS should consider all of the factors identified to determine business economic hardship together, and no single factor should be dispositive.

Permitting levy releases for business economic hardship will necessarily change the collection methods and alternatives the IRS uses for businesses. The IRS will likely need to revise the regulations for ETA OICs, and the IRS will likely modify its procedures for levies, IAs, OICs, and CNC status. This recommendation may result in more business economic hardship determinations by the IRS in economic downturns, and fewer in times of prosperity.<sup>32</sup>

<sup>31</sup> Treas. Reg. § 301.6343-1(b)(4)(i) (quoted above).

<sup>32</sup> The National Taxpayer Advocate notes that if the IRS modified its policies for collection enforcement and collection alternatives to resolve more cases without enforced collection, it would reduce the need for levy releases due to economic hardship. National Taxpayer Advocate 2010 Annual Report to Congress 85-97 (Most Serious Problem: *IRS Collection Policies and Procedures Fail to Adequately Protect Taxpayers Suffering an Economic Hardship*), 302-310 (Status Update: *The IRS Has Been Slow to Address the Adverse Impact of its Lien-Filing Policies on Taxpayers and Future Tax Compliance*), vol. 2 39-70 (*An Analysis of the IRS Collection Strategy: Suggestions to Increase Revenue, Improve Taxpayer Service, and Further the IRS Mission*); National Taxpayer Advocate 2009 Annual Report to Congress 196-212 (Most Serious Problem: *The Steady Decline of the IRS Offer in Compromise Program is Leading to Lost Opportunities for Taxpayers and the IRS Alike*); National Taxpayer Advocate 2008 Annual Report to Congress 54-78 (Most Serious Problem: *Employment Taxes*); National Taxpayer Advocate 2007 Annual Report to Congress 395-410 (Most Serious Problem: *Assessment and Processing of the Trust Fund Recovery Penalty (TFRP)*); National Taxpayer Advocate 2006 Annual Report to Congress 62-82 (Most Serious Problem: *Early Intervention in IRS Collection Cases*); National Taxpayer Advocate 2004 Annual Report to Congress 226-245 (Most Serious Problem: *IRS Collection Strategy*).

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#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.<sup>1</sup> Many special tax 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.<sup>2</sup> Misunderstanding the rules may leave these taxpayers charged with a penalty of a fifth of their denied claim, even if they started with no taxable income from which to pay.<sup>3</sup> To a taxpayer who has attempted to understand and comply with the tax law, a penalty for merely asking for a refund that the IRS denies adds insult to injury.

**EXAMPLE**

The Code allows a First-Time Homebuyer Credit (FTHBC) in certain cases where the buyer enters into a written binding contract before May 1, 2010, and buys the home before October 1, 2010.<sup>4</sup> Taxpayer X responded to an advertisement from a real estate agent describing the FTHBC as a new government program that would help make the dream of home ownership a reality. In April of 2010, X found a home but chose not to proceed with the purchase due to various circumstances. That summer, the agent advised X that the deadline for the FTHBC had been extended, and pushed X to close on the home by September. The agent said closing by September would be soon enough, explaining in a letter that X had a “meeting of minds” with the seller as of April that would qualify X for the FTHBC. On a 2010 federal tax return properly showing no tax due (beyond that covered by withholding), X, a high school graduate with no significant tax knowledge or experience, claims the \$8,000 credit. The IRS examines the return and determines that a “meeting of minds” does not meet the requirement of entering into a binding contract before May 1, 2010. Denying the refund claim, the IRS assesses X a \$1,600 penalty (to be paid with no opportunity for a hearing in the United States Tax Court) despite X’s reliance on the real estate agent’s advice and letter, and despite X’s lack of education, knowledge, or experience with taxes.

<sup>1</sup> See Internal Revenue Code (IRC) §§ 36, 36B, 45R.

<sup>2</sup> On the characteristics of taxpayer segments, see *supra* Introduction to Diversity Issues: The IRS Should Do More to Accommodate Changing Taxpayer Demographics and sources cited therein.

<sup>3</sup> See IRC § 6676.

<sup>4</sup> IRC § 36.

## RECOMMENDATION

Amend the erroneous refund penalty under IRC § 6676 to permit relief from a penalty for erroneously claiming a refund pursuant to a refundable credit if the taxpayer acted with reasonable cause and in good faith.

## PRESENT LAW

Generally, an accuracy-related penalty adds 20 percent of an underpayment attributable to negligence, substantial understatement (*i.e.*, failing to show ten percent of the correct tax or \$5,000, whichever is more), or certain other factors to any tax otherwise owed.<sup>5</sup> The IRS will not impose the penalty if the taxpayer acted with reasonable cause and in good faith.<sup>6</sup> Among the facts and circumstances indicating reasonable cause and good faith are the taxpayer's experience, knowledge, and education, or reliance on professional advice.<sup>7</sup>

The accuracy-related penalty depends on underpayment, and according to the Department of the Treasury, disallowance of "a refund or credit claim does not result in an underpayment."<sup>8</sup> In 2007, the Treasury proposed a new penalty on erroneous refunds for this reason, stating that absent "a frivolous position evident on the face of the return, there is no accuracy-related penalty applicable to disallowance of a refund or credit claim."<sup>9</sup> At the same time, the Treasury proposal recommended relief in case of reasonable cause or reasonable basis: "A penalty would be imposed in the amount of up to 20 percent of a disallowed portion of a claim for refund or credit for which there is no reasonable basis for the claimed tax treatment or for which the taxpayer did not have reasonable cause."<sup>10</sup>

That year, Congress enacted an assessable penalty of 20 percent of an excessive claim for refund. It does not apply to claims for the earned income tax credit (EITC) or to claims having a reasonable basis.<sup>11</sup> Generally, reasonable basis means reliance on authorities such as rulings or legislative history.<sup>12</sup> As enacted, the provision does not allow relief for reasonable cause. The erroneous refund penalty does not apply where the accuracy-related penalty applies.<sup>13</sup>

<sup>5</sup> IRC § 6662.

<sup>6</sup> IRC § 6664(c).

<sup>7</sup> Treas. Reg. § 1.6664-4.

<sup>8</sup> Dep't of the Treas., *Gen. Explanations of the Admin's FY 2008 Rev. Proposals* (Feb. 2007) at 82. Nonetheless, the IRS characterizes an erroneously claimed refundable credit as an amount that contributes to an understatement. See Serv. Ctr. Adv. 2001-12-001 (dated Nov. 8, 1999, released Mar. 23, 2001); see also Program Manager Tech. Assistance 2011-03 (Aug. 27, 2010); Program Manager Tech. Assistance 2010-01 (Nov. 20, 2009). If, however, the IRS denies the claim before paying it, the IRS characterizes the denied claim as an amount assessed or collected for purposes of computing the accuracy-related penalty. An amount assessed or collected cannot be considered as underpaid. See Serv. Ctr. Adv. 1998-032 (dated Aug. 10, 1998, released Dec. 4, 1998).

<sup>9</sup> *Gen. Explanations of the Admin's FY 2008 Rev. Proposals* at 82.

<sup>10</sup> *Id.* Likewise, commentators observed that prior "to the 2007 Act, there was no applicable penalty imposed on a disallowed, nonfrivolous refund claim." Fisk & Lee, *Section 6676 Erroneous Claim for Refund or Credit Penalty*, 1 Tax Dev't J. 3 (2009).

<sup>11</sup> IRC § 6676 added by Pub. L. No. 110-28, § 8247, 121 Stat. 112, 204 (2007).

<sup>12</sup> Treas. Reg. § 1.6662-3(b)(3).

<sup>13</sup> IRC § 6676(d).

## REASONS FOR CHANGE

While enactment of the erroneous refund penalty closed the gap where the accuracy-related penalty did not apply, the 2007 legislation was overbroad. 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, especially in the case of special tax breaks designed as refundable credits.

Because the accuracy-related penalty applies only in case of underpayment, commentators have observed:

Prior to enactment of § 6676, there was strategic advantage for taxpayers to reserve tax positions for which there was less than a compelling level of authority to amended returns as there was no penalty for these positions taken in good faith, and, outside of a potential criminal sanction for filing false claims, there was little consequence for positions taken in bad faith.<sup>14</sup>

In other words, a refund may arise not only from a credit designed as refundable but from strategic placement of an argumentative tax claim on an amended return by a sophisticated taxpayer.<sup>15</sup> To the extent that the 2007 legislation contemplated sophisticated abuse, exception only in case of reasonable basis made sense. Nevertheless, the erroneous refund penalty now applies even to inadvertent errors by unsophisticated taxpayers.

By carving out EITC, the § 6676 legislation recognized this issue for the best-known of the refundable credits.<sup>16</sup> Since 2007, however, these credits have proliferated. In particular, the First-Time Homebuyer, Making Work Pay, health care, adoption, and American Opportunity tax credits were enacted or made refundable after creation of the erroneous refund penalty.<sup>17</sup> For business taxpayers, 2008 economic emergency legislation, in a provision expanded by the American Recovery and Reinvestment Act of 2009 as well as 2010 extender legislation, created an election to accelerate alternative minimum tax (AMT) or research credits in lieu of that year's bonus depreciation and made the amount refundable.<sup>18</sup> Because these significant refundable credits came into being after 2007, the erroneous refund penalty legislation could not have anticipated and provided exceptions for them.<sup>19</sup>

<sup>14</sup> 1 Tax Dev't J. at 7-8.

<sup>15</sup> On amended returns and sophisticated claims, see, e.g., *Eustace v. Comm'r*, T.C. Memo. 2001-66 (describing the use of amended returns to claim refunds of research credit), aff'd, 312 F.3d 905 (7th Cir. 2002); *Union Carbide v. Comm'r*, T.C. Memo. 2009-50 (describing multi-million dollar research credits).

<sup>16</sup> See, e.g., Daniel P. Gitterman, Lucy S. Gorham & Jessica L. Dorrance, *Expand the EITC for Single Workers and Couples Without Children*, Policy Brief Prepared for the Ctr. on Poverty, Work & Opportunity, Univ. of N.C. at Chapel Hill 1 (Jan. 2007) (calling EITC "the nation's largest anti-poverty program").

<sup>17</sup> IRC §§ 36, 36A, 36B, 36C, 25A; see also IRC § 45R(f) (relating to refundability of health care credit for small tax-exempt employer).

<sup>18</sup> IRC § 168(k)(4) as amended by Pub. L. Nos. 110-289, § 3081, 122 Stat. 2654, 2903 (2008), 111-5, Div. B, § 1201, 123 Stat. 115, 333 (2009), & 111-240, § 2022, 124 Stat. 2504, 2558 (2010).

<sup>19</sup> Historically, special tax breaks have taken the form of refundable credits at least since 1965 when an IRC § 34 refundable fuel tax credit was allowed to farmers and certain other taxpayers. See Pub. L. No. 89-44, § 809, 79 Stat. 136, 165. Part of the IRC § 24 child tax credit known as the additional child tax credit is refundable, as is an IRC § 35 health insurance credit for displaced workers enacted within the Trade Act of 2002, Pub. L. No. 107-210, § 201, 116 Stat. 933, 954. Technically, refunds of over-withholding are effectuated through refundable credits in IRC §§ 31 & 33.

## EXPLANATION OF RECOMMENDATION

Allowing a taxpayer to present reasonable cause for an error would be consistent with the purpose of refundable credits, which generally are economic incentives, designed to encourage certain behaviors, and structured as special tax breaks.<sup>20</sup> The proposed amendment to IRC § 6676 would be consistent with the 2007 legislation, which excepted the refundable credit best-known at the time (the EITC).<sup>21</sup>

Otherwise, the erroneous refund penalty could be unduly harsh to an extent not contemplated at enactment. One possibly unforeseen consequence is that a hapless taxpayer targeted for a special tax break could be charged by the IRS for payment of an erroneous refund penalty without recourse to the Tax Court.<sup>22</sup> By contrast, if the accuracy-related penalty applied, the taxpayer would have an opportunity to present reasonable cause to the IRS, and if necessary to contest the penalty in the Tax Court before paying it. This procedural opportunity arises because the accuracy-related penalty is classified as an addition to tax rather than an assessable penalty.<sup>23</sup>

<sup>20</sup> See National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 75 (Research Study: *Running Social Programs Through the Tax System*); National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 101 (Research Study: *Evaluate the Administration of Tax Expenditures*).

<sup>21</sup> As discussed above, the 2007 legislation allowed relief for reasonable basis, which the proposed reasonable cause relief would parallel procedurally. IRM 20.1.5.14.3 (July 1, 2008) states that rules on IRC § 6676 reasonable basis will be prescribed by regulation. Inasmuch as IRM 8.11.1.2 (Aug. 15, 2008) allows post-assessment penalty appeal, the recommended legislation would confirm a taxpayer's right to appeal a denial of reasonable cause relief.

<sup>22</sup> RC § 6671. IRM 8.11.1.2 (Aug. 15, 2008) allows post-assessment penalty appeal within the IRS.

<sup>23</sup> IRC § 6665.

LR  
#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) against the taxpayer, 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 request.<sup>1</sup> Appeals holds informal CDP hearings face-to-face, by telephone, or through correspondence.<sup>2</sup> After a hearing, Appeals issues a notice of determination (NOD), giving the taxpayer 30 days to petition for Tax Court review.<sup>3</sup>

Appeals officers are not required to review or consider information submitted by the taxpayer after Appeals issues the notice.<sup>4</sup> In some cases, Appeals issues an NOD before the taxpayer has had an opportunity to present information, because the taxpayer is unavailable at the time of the hearing, or the Appeals officer has not received the information before issuing the determination. After the IRS issues the NOD, the taxpayer faces a tough choice: to either forego Tax Court review and work with IRS Collection, seek an audit reconsideration from IRS Examination, or petition the Tax Court for a return or remand of the case to Appeals for a supplemental hearing. The inability of Appeals to rescind the NOD and rehear issues in appropriate cases may deprive some taxpayers of meaningful hearings, create a delay in resolving a taxpayer's case, and unnecessarily use Tax Court and IRS resources.

**EXAMPLE ONE**

A taxpayer timely files his 2009 return, but cannot pay \$10,500 in tax reported on the return. The IRS files an NFTL against the taxpayer's property, reporting the taxpayer's liability plus penalties and interest, and issues Letter 3172, *Notice of Federal Tax Lien Filing and Your Right to a Hearing Under IRC 6320*. The taxpayer timely files Form 12153, *Request for Collection Due Process Hearing*, and requests a hearing to seek lien subordination so he can borrow from the equity in his home to pay for a medical procedure.

The settlement officer (SO) schedules a hearing by telephone. On the day of the hearing, the taxpayer's illness forces him to go to the hospital, and he does not make the call. The SO tries to call the taxpayer but is unsuccessful and issues an NOD sustaining the lien. The next week, the taxpayer contacts the SO, explaining that he missed the hearing because he was hospitalized and asking the SO to schedule a new hearing to discuss his subordination request. The SO explains that he cannot do that because once Appeals issues an NOD it

<sup>1</sup> See generally Internal Revenue Code (IRC) §§ 6320 & 6330.

<sup>2</sup> IRC §§ 6330(b)(1) & 6330(b)(3). Treas. Reg. § 301.6330-1(d)(2) Q & A-D6 & D7.

<sup>3</sup> IRC § 6330(d). Treas. Reg. § 301.6330-1(e)(3) Q & A-E8.

<sup>4</sup> Internal Revenue Manual (IRM) 8.22.2.2.4.12 (Oct. 30, 2007).

cannot be rescinded, even if there is new information to consider. The taxpayer petitions Tax Court for review of the determination, and the court remands the case to Appeals for consideration of new information.

### EXAMPLE TWO

A small business taxpayer misses its quarterly payroll tax deposits of roughly \$50,000 for the first quarter of 2010 because its business manager failed to pay the deposits before he embezzled money and disappeared. The company stays in business by obtaining a line of credit secured by its accounts receivable, but the debt service makes it difficult for the firm to pay the delinquent quarter unless it lays off some employees. The IRS issues Letter 1058, *Final Notice: Notice of Intent to Levy and Notice of Your Right to a Hearing*, to the taxpayer. The taxpayer requests a face-to-face hearing seeking an installment agreement.

The SO sends a letter requesting that the taxpayer submit Form 433-B, *Collection Information Statement for Businesses*, within 15 days. The taxpayer timely submits the form and the SO holds a hearing at which she and the taxpayer agree an offer in compromise is the best collection alternative. The SO gives the taxpayer 15 calendar days to submit Form 656, *Offer in Compromise*. The taxpayer sends the form in on time but the mail is misrouted and does not reach the SO for 30 days. Before the SO receives the Form 656, she issues the NOD sustaining the levy. The taxpayer asks the SO to reconsider her decision sustaining the levy in light of the offer request. The SO states that she would like to consider the offer but cannot because the NOD cannot be rescinded. The taxpayer petitions the Tax Court, which remands the case to Appeals to consider the offer.

### RECOMMENDATION

The National Taxpayer Advocate recommends that Congress amend Internal Revenue Code § 6330 to permit the IRS Office of 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.

### PRESENT LAW

The Code does not authorize Appeals to rescind CDP NODs. Appeals issues its NOD, setting forth its findings and decisions concerning the proposed levy or filed lien, at the conclusion of the CDP hearing. The NOD includes verification of whether the IRS met the requirements of applicable law and procedures, resolution of any relevant issues raised by the taxpayer, and a finding of whether the proposed collection action balances the need for the efficient collection of taxes and the taxpayer's legitimate concern that any collection action be no more intrusive than necessary.<sup>5</sup> Within 30 days of Appeals' determination,

<sup>5</sup> Treas. Reg. §§ 301.6320-1(e)(3) A-E8 & 301.6330-1(e)(3) A-E8(i).

the taxpayer is entitled to appeal the NOD to the Tax Court.<sup>6</sup> Taxpayers are entitled to only one CDP levy hearing and one CDP lien hearing per taxable period to which an unpaid tax relates.<sup>7</sup>

The CDP NOD is the jurisdictional equivalent of a notice of deficiency.<sup>8</sup> Each notice provides the final administrative determination by the IRS on a specific collection action or understatement of tax.<sup>9</sup> IRS Examination or Appeals generally sends a notice of deficiency to the taxpayer after the IRS determines that a taxpayer's return underreports an amount of income, estate, or gift tax, and the taxpayer disagrees with the adjustment after having an opportunity for a conference with Appeals.<sup>10</sup> Within 90 days (or 150 days for taxpayers with addresses outside the United States) of the date on the notice of deficiency, the taxpayer is entitled to petition the Tax Court for a redetermination of the deficiency.<sup>11</sup>

With respect to notices of deficiency, but with no reference to CDP NODs, IRC § 6212(d) provides that the IRS may, with the consent of the taxpayer, rescind any notice of deficiency mailed to the taxpayer. However, the IRS cannot rescind deficiency notices after the taxpayer petitions the Tax Court because the court has jurisdiction over the matter at that point.<sup>12</sup>

## REASONS FOR CHANGE

Under present law, the IRS may be constrained from affording some taxpayers the opportunity for a meaningful CDP hearing, delaying resolution and creating additional cases for Tax Court review. The Tax Court remands cases to Appeals when they are factually incomplete and need development, or Appeals abused its discretion.<sup>13</sup> The Tax Court remanded 10.4 percent of its CDP cases in FY 2010.<sup>14</sup> Appeals should be able to rescind CDP NODs when it determines that it did not consider or review information that could

<sup>6</sup> IRC §§ 6320(c) & 6330(d)(1).

<sup>7</sup> IRC §§ 6320(b)(2) & 6330(b)(2).

<sup>8</sup> *Offiler v. Comm'r*, 114 T.C. 492, 498 (2000).

<sup>9</sup> See, e.g., IRC § 6330(c)(2)(B) which provides that a taxpayer may raise the underlying tax liability in a CDP hearing, among other collection issues, if the taxpayer has not received a notice of deficiency or otherwise had an opportunity to dispute the liability. IRC § 6212(c) provides that after a taxpayer timely petitions the Tax Court for a redetermination of a deficiency, the IRS generally may not determine any additional deficiency with respect to the income, estate, or gift tax for the same tax period.

<sup>10</sup> IRC § 6212. Treas. Reg. §§ 601.103, 601.105(d)(iv), 601.106(b) & 601.106(d)(2)(ii).

<sup>11</sup> IRC § 6213(a).

<sup>12</sup> *Comm'r v. Shapiro*, 424 U.S. 614, 630 (1976).

<sup>13</sup> See *Wadleigh v. Comm'r*, 134 T.C. 280 (2010) (remand for clarification of the record); *Alessio Azari, Inc. v. Comm'r*, 136 T.C. No. 9 (2011) (remand for abuse of discretion).

<sup>14</sup> Appeals, ACDS, *Diagnostics and Balanced Appeals Measures Report System* (FY 2010). IRS Chief Counsel, Counsel Automated Tracking System, PPL3254 (FY 2010). TAS compared the number of cases remanded per the ACDS over the number of cases disposed by the Tax Court.

materially change the resolution in the taxpayer's determination.<sup>15</sup> Providing Appeals with the discretion to rescind an NOD with the taxpayer's consent will save taxpayer and IRS resources by allowing Appeals to correct for unavoidable or excusable procedural delays and missteps, while protecting the taxpayer's right to Tax Court review where differences are irreconcilable.

### EXPLANATION OF RECOMMENDATION

The recommendation permits the IRS to rescind NODs within 30 days of the date of the determination, and only before the taxpayer has petitioned the Tax Court. The recommendation authorizes Appeals to rescind an NOD when the taxpayer and Appeals agree to rescind.<sup>16</sup> The recommendation will give taxpayers the choice, in the 30-day period from the date of Appeals' determination, to either seek consideration of new information by Appeals, or proceed to the Tax Court to challenge the NOD.

<sup>15</sup> Notwithstanding the general rule prohibiting rescission of CDP Notices of Determination, Appeals has proposed the administrative practice of amending the NOD within the 30-day period to petition Tax Court if: the NOD is clearly in error; the taxpayer has not petitioned Tax Court; and the correction can be made within the 30-day period to petition Tax Court. Although this procedure obviates the problem in some cases, it would not assist taxpayers where more than 30 days would be needed to adequately evaluate the taxpayer's case, or where the taxpayer filed a petition unaware that Appeals was amending its determination. Moreover, this procedure may serve to confuse taxpayers and lead them to forego Tax Court review.

<sup>16</sup> Permitting Appeals to rescind NODs unilaterally would be ineffective, because once Appeals issues an NOD, the taxpayer has a right to proceed to Tax Court. It is unlikely the Tax Court would refuse to consider a timely filed petition on the ground that Appeals unilaterally rescinded a valid NOD.

LR #8

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

### PROBLEM

When the appropriation of funds for a federal agency for a fiscal year expires without a continuing resolution or new appropriation for the current fiscal year, the Anti-Deficiency Act generally prohibits the agency from incurring obligations to pay its employees.<sup>1</sup> During these periods of “lapsed appropriations,” the agency may only expend funds as necessary to bring about the orderly termination of its functions.<sup>2</sup> An agency is also prohibited from employing the personal services of its employees even without incurring obligations to pay them, but with an important exception: “for emergencies involving the safety of human life or the protection of property.”<sup>3</sup>

In 2011, the IRS developed two shutdown contingency plans in anticipation of lapses in appropriations, one during the filing season and one during the nonfiling season.<sup>4</sup> Both plans reflect the IRS and the Department of Treasury position that the emergency life and property exception applies to agency functions that are in essence public safety or police powers. The National Taxpayer Advocate believes the IRS’s shutdown contingency plan prevents it from assisting taxpayers even in emergencies involving the safety of human life or the protection of property. The National Taxpayer Advocate’s authority to issue Taxpayer Assistance Orders (TAOs) pursuant to Internal Revenue Code (IRC) § 7811 does not explicitly include the authority to incur obligations in advance of appropriations and thus may not compensate for the current inability to assist taxpayers.<sup>5</sup>

### EXAMPLE

A low income taxpayer who does not have access to a computer claims a refund on her timely filed paper tax return. She intends to use the money to pay past-due heating and electricity bills and purchase medical supplies to treat her diabetes. Because the appropriation of funds has expired, and the IRS concludes there is no reasonable connection between

<sup>1</sup> 31 U.S.C. § 1341(a). A continuing resolution is “An appropriation act that provides budget authority for federal agencies, specific activities, or both to continue in operation when Congress and the President have not completed action on the regular appropriation acts by the beginning of the fiscal year.” Government Accountability Office, GAO-05-734SP, *A Glossary of Terms Used in the Federal Budget Process* (2005), 35-36 available at <http://www.gao.gov/new.items/d05734sp.pdf>.

<sup>2</sup> *Applicability of the Antideficiency Act Upon A Lapse in Agency Appropriations*, 43 Op. Att’y Gen. 224 (1980).

<sup>3</sup> 31 U.S.C. § 1342.

<sup>4</sup> Filing season is the period January through April, when most taxpayers file their tax returns. IRS, *FY 2012 Shutdown Contingency Plan* (Rev. Nov. 16, 2011), available at <http://www.whitehouse.gov/omb/contingency-plans> (last visited Dec. 21, 2011) contemplates a lapse in appropriations other than during filing season. IRS, *FY 2011 Shutdown Contingency Plan* (Rev. Apr. 7, 2011) available at [http://www.treasury.gov/connect/blog/Documents/IRS-Funding\\_Lapse\\_Contingency\\_Plan2011.PDF](http://www.treasury.gov/connect/blog/Documents/IRS-Funding_Lapse_Contingency_Plan2011.PDF) contemplates a lapse in appropriations during filing season.

<sup>5</sup> IRC § 7811 authorizes the National Taxpayer Advocate, by means of a TAO, to require the Secretary of Internal Revenue to release a levy or “cease any action, take any action as permitted by law, or refrain from taking any action, with respect to the taxpayer” when the National Taxpayer Advocate “determines the taxpayer is suffering or about to suffer a significant hardship as a result of the manner in which the internal revenue laws are being administered by the Secretary.”

the agency's function and the safety of the taxpayer's life or the protection of her property, the IRS does not process the taxpayer's return or issue her refund. The taxpayer may ask TAS for assistance, but TAS does not have authority to process returns. Moreover, even if the number of TAS employees permitted to continue working under the IRS contingency plan is sufficient to provide immediate assistance, the number of other IRS employees permitted to continue to work may be insufficient to handle TAS's requests. With no one able to help her obtain a refund, the taxpayer does not pay her utility bills, and the services are disconnected. Without heat and electricity, she cannot remain in her home and is forced to find shelter elsewhere, and cannot buy the medical supplies she needs to treat her diabetes.

### 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 TAOs 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 TAO issued under IRC § 7811.

### CURRENT LAW

Article I of the Constitution provides that "No Money shall be drawn from the Treasury, but in Consequence of Appropriations made by Law."<sup>6</sup> The Anti-Deficiency Act implements this provision. Section 1341(a)(1)(B) of Title 31 forbids any officer or employee of the United States government or of the District of Columbia government to involve their respective government employers in a contract or obligation for the payment of money before an appropriation is made unless authorized by law.<sup>7</sup> A significant exception to this rule is section 1342 of Title 31, which permits such government activity "for emergencies involving the safety of human life or the protection of property."<sup>8</sup> A similar provision under Title 31, section 1515(b)(1)(B), prohibits the apportionment or reapportionment of appropriated funds in a manner that would give rise to a deficiency or require a supplemental appropriation (*i.e.*, expending funds at a rate that could not be sustained for the entire fiscal

<sup>6</sup> U.S. Const. Art I, § 9, cl. 7.

<sup>7</sup> 31 U.S.C. § 1341(a)(1)(B) (formerly § 665(a), redesignated as § 1341 by Pub. L. No. 97-208, 96 Stat. 921 (1982)). Paying employees in the absence of an appropriation for that purpose is not "authorized by law." Compare with the authority to incur, in advance of appropriations, those minimal obligations necessary to close an agency, which would fall within the "authorized by law" exception to the statute. See *Applicability of the Antideficiency Act Upon A Lapse in Agency Appropriations*, 43 Op. Att'y Gen. 224 (1980).

<sup>8</sup> This portion of the Anti-Deficiency Statute, when it was originally enacted in 1884, forbade unauthorized employment "except in cases of sudden emergency involving the loss of human life or the destruction of property." In 1950, Congress revised this portion of the statute by substituting "cases of sudden emergency" with "cases of emergency," substituting "loss of human life" with "safety of human life," and substituting "destruction of property" with "protection of property." The provision appeared as section 665(b) of Title 31 until 1982 when it was redesignated as § 1342 by Pub. L. No. 97-208, 96 Stat. 921 (1982).

year without a deficiency) except in, among other circumstances, “emergencies involving the safety of human life, [or] the protection of property.”<sup>9</sup> The Attorney General noted that:

Activities for which deficiency apportionments have been granted on this basis [former § 665(e)(1)(B), now § 1515(b)(1)(B)] include FBI criminal investigations, legal services rendered by the Department of Agriculture in connection with state meat inspection programs and enforcement of the Wholesome Meat Act of 1967, the protection and management of commodity inventories by the Commodity Credit Corporation, and the investigation of aircraft accidents by the National Transportation Safety Board. These few illustrations demonstrate the common sense approach that has guided the interpretation of [former § 665(e), now § 1515]. Most important, under § 665(e)(2) [now § 1515(b)(1)(B)], each apportionment or reapportionment indicating the need for a deficiency or supplemental appropriation has been reported contemporaneously to both Houses of Congress, and, in the face of these reports, Congress has not acted in any way to alter the relevant 1950 wording of § 665(e)(1)(B) [now § 1515(b)(1)(B)], which is, in this respect, identical to § 665(b) [now § 1342].<sup>10</sup>

Based on these observations, the Attorney General in 1981 articulated two rules for identifying functions that would fall under the exception of § 1342:

First, there must be some reasonable and articulable connection between the function to be performed and the safety of human life or the protection of property. Second, there must be some reasonable likelihood that the safety of human life or the protection of property would be compromised, in some degree, by delay in the performance of the function in question.<sup>11</sup>

Section 1342 was amended in 1990 to add: “As used in this section, the term ‘emergencies involving the safety of human life or the protection of property’ does not include ongoing, regular, functions of the government the suspension of which would not imminently threaten the safety of human life or the protection of property.”<sup>12</sup> The Attorney General clarified that the earlier interpretation continues to be sound legal analysis, with one modification. The second rule – that there must be some reasonable likelihood that the safety of human life or the protection of property would be compromised, in some degree, by delay

<sup>9</sup> 31 U.S.C. § 665(e)(1)(B), redesignated as § 1515(b)(1)(B) by Pub. L. No. 97-208, 96 Stat. 921 (1982).

<sup>10</sup> *Authority for the Continuance of Government Functions During a Temporary Lapse in Appropriations*, 43 Op. Att’y Gen. 293, 304-305 (1981) (fn. refs. omitted). The Attorney General observed that §§ 665(e)(1)(B) (now § 1515(b)(1)(B)) and 665(b) (now § 1342) “containing the same language, enacted at the same time, and aimed at related purposes...should be deemed *in pari materia* [on the same subject] and given a like construction.” *Id.* note 11.

<sup>11</sup> *Authority for the Continuance of Government Functions During a Temporary Lapse in Appropriations*, 43 Op. Att’y Gen. 293, 302 (1981). Moreover, “Congress would intend those persons so employed to be able to accomplish their emergency functions with success. Congress, for example, having allowed the Government to hire firefighters must surely have intended that water and firetrucks would be available to them.” *Id.* at 306.

<sup>12</sup> See Act of Nov. 5, 1990, Pub. L. No. 101-508, Title XIII, Subtitle B, § 13213(b), 104 Stat. 1388-621 (amending 31 U.S.C. § 1342 (1982)).

in the performance of the function in question – should be modified to replace “in some degree” with “in some significant degree.”<sup>13</sup>

## REASONS FOR CHANGE

The IRS’s shutdown contingency plans permit three categories of activity during a lapse in appropriations: “Activities otherwise authorized by law;” “Activities necessary to safeguard human life or protect *government* property;” and “Activities necessary for orderly agency shutdown.”<sup>14</sup> The only examples the plans provide of permissible activity in the second category that mention the protection of life or property are: “Administering contracts related to safety of human life or protection of Government property,” “Protecting Federal lands, buildings, and other property owned by the United States,” and “Maintaining minimal building facilities personnel to maintain safe conditions for essential Personnel.”<sup>15</sup> Some return processing, and all automated collection activity, would be permissible under the second category of excepted activity. As the filing season contingency plan notes, “as a practical matter, the IRS’s automated tax processing system would not allow for an interruption during the filing season in processing electronically filed tax returns of any kind, whether involving remittances or refunds.”<sup>16</sup> Consequently, the IRS contingency plans provide that it will continue to process e-filed returns, both those with payments and those claiming refunds, to avoid disrupting automated systems.<sup>17</sup> The IRS also will process payments submitted with paper returns because these receipts constitute government property. However, the IRS will not issue refunds claimed on paper returns, and will issue refunds claimed on electronically filed returns only if they would not require manual processing.<sup>18</sup> Nor will the IRS provide taxpayer account assistance by operating service centers or call sites except to the extent that it would enable taxpayers to meet their filing obligations. Even this limited assistance will be available only if the lapse in appropriations occurs

<sup>13</sup> Memorandum for Alice Rivlin, Director, Office of Management and Budget (Aug. 16, 1995) available at [http://www.opm.gov/furlough/OMBGuidance/Attachment\\_A-1.pdf](http://www.opm.gov/furlough/OMBGuidance/Attachment_A-1.pdf).

<sup>14</sup> IRS, *FY 2012 Shutdown Contingency Plan* (Rev. Nov. 16, 2011) (emphasis added), 1-2, available at <http://www.whitehouse.gov/omb/contingency-plans> (last visited Dec. 21, 2011); IRS, *FY 2011 Shutdown Contingency Plan* (Rev. Apr. 7, 2011) 1-3, available at [http://www.treasury.gov/connect/blog/Documents/IRS-Funding\\_Lapse\\_Contingency\\_Plan2011.PDF](http://www.treasury.gov/connect/blog/Documents/IRS-Funding_Lapse_Contingency_Plan2011.PDF).

<sup>15</sup> IRS, *FY 2012 Shutdown Contingency Plan* (Rev. Nov. 16, 2011), 6, available at <http://www.whitehouse.gov/omb/contingency-plans> (last visited Dec. 21, 2011); IRS, *FY 2011 Shutdown Contingency Plan* (Rev. Apr. 7, 2011) 6, available at [http://www.treasury.gov/connect/blog/Documents/IRS-Funding\\_Lapse\\_Contingency\\_Plan2011.PDF](http://www.treasury.gov/connect/blog/Documents/IRS-Funding_Lapse_Contingency_Plan2011.PDF).

<sup>16</sup> IRS, *FY 2011 Shutdown Contingency Plan* (Rev. Apr. 7, 2011), 2, available at [http://www.treasury.gov/connect/blog/Documents/IRS-Funding\\_Lapse\\_Contingency\\_Plan2011.PDF](http://www.treasury.gov/connect/blog/Documents/IRS-Funding_Lapse_Contingency_Plan2011.PDF).

<sup>17</sup> Continuing to operate the automated systems protects the government’s property by maintaining the integrity of the systems and preventing loss of data. Moreover, the IRS cannot determine whether a return is a remittance or a refund return without some processing.

<sup>18</sup> Once an electronically filed refund return clears the automated processing system, manual intervention is required to prevent the issuance of the refund. Conversely, if the processing system interrupts the issuance of the refund, manual processing may be required to issue the refund. Manual processing is required for a number of reasons, such as when a hardship situation necessitates a more rapid refund than normal systemic processing can provide. See IRM 21.4.4.2 (Apr. 11, 2011).

during filing season.<sup>19</sup> Meanwhile, lien and levy activities carried out by automation will continue.<sup>20</sup> While some personnel employed to protect government property could help callers with levy releases, there is no mechanism to ensure that taxpayers facing immediate financial hardship will receive assistance.<sup>21</sup> TAS may be the only place taxpayers can turn for assistance — and under the most recent contingency plan, only 58 TAS employees are authorized to continue to work.<sup>22</sup>

Other federal agencies have not taken such a restrictive view of the emergency exception. For example, the Securities and Exchange Commission's contingency plan provides that it will handle "emergency enforcement matters, including temporary restraining orders and/or investigative steps necessary to protect public and private property" and "emergency examinations and inspections to protect public and private property."<sup>23</sup> The Department of Justice's contingency plan, in addition to permitting activities relating to law enforcement that may or may not affect government property or the lives of government employees,<sup>24</sup> provides that its U.S. Trustees Program will continue to "protect bankruptcy estate property [which is not government property] through the appointment and oversight of fiduciaries and through other means."<sup>25</sup>

<sup>19</sup> IRS, *FY 2011 Shutdown Contingency Plan* (Rev. Apr. 7, 2011), 2, available at [http://www.treasury.gov/connect/blog/Documents/IRS-Funding\\_Lapse\\_Contingency\\_Plan2011.pdf](http://www.treasury.gov/connect/blog/Documents/IRS-Funding_Lapse_Contingency_Plan2011.pdf) ("If a shutdown occurs during the filing season, therefore, 'tax collecting activity,' which is an established excepted function to protect property, may encompass operating service centers and call sites to the extent necessary to enable taxpayers to meet their filing obligation."); IRS, *FY 2012 Shutdown Contingency Plan* (Rev. Nov. 16, 2011), 7, available at <http://www.whitehouse.gov/omb/contingency-plans> (last visited Dec. 21, 2011) (listing as an example of impermissible, non-excepted activities "Taxpayer services such as responding to taxpayer questions (call sites) (during Non-Filing Season)").

<sup>20</sup> See note 17, *supra*, pertaining to continued operations of IRS automated systems. As the National Taxpayer Advocate has observed, "The IRS now generates a majority of its liens through the ACS [Automated Collection System]...Most ACS liens are issued systemically, i.e., the lien-filing determinations are driven by IRS 'business rules' and procedural requirements, with little or no employee involvement or judgment in the decision-making process...In these situations,...the ACS does not determine the impact of the liens on the affected taxpayers, or whether they own any assets requiring a lien to protect the government's interests." National Taxpayer Advocate 2010 Annual Report to Congress, vol. 2, *An Analysis of the IRS Collection Strategy: Suggestions to Increase Revenue*, 53 (fn. refs. omitted). The National Taxpayer Advocate also observed, "The use of the systemically generated levy has been the primary ACS contact strategy almost from its inception, and in recent years, from FYs 2006 through 2010, the ACS has averaged approximately 3.4 million levies per year." *Id.* at 52.

<sup>21</sup> IRS, *FY 2011 Shutdown Contingency Plan* (Rev. Apr. 7, 2011), 38, available at <http://www.whitehouse.gov/omb/contingency-plans> (last visited Dec. 21, 2011) refers to 1,263 excepted "ACS [employees] to handle levy release telephone calls from taxpayers." IRS, *FY 2012 Shutdown Contingency Plan* (Rev. Nov. 16, 2011), available at <http://www.whitehouse.gov/omb/contingency-plans> (last visited Dec. 21, 2011) does not contain any provision for retaining employees to assist with levy releases.

<sup>22</sup> IRS, *FY 2012 Shutdown Contingency Plan* (Rev. Nov. 16, 2011), 21, available at <http://www.whitehouse.gov/omb/contingency-plans> (last visited Dec. 21, 2011).

<sup>23</sup> Securities and Exchange Commission, *Plan of Operations During a Lapse in Appropriations* (Dec. 14, 2011), 5 available at [http://www.sec.gov/about/2011\\_fed\\_shutdown\\_contingency\\_plan.pdf](http://www.sec.gov/about/2011_fed_shutdown_contingency_plan.pdf) (last visited Dec. 21, 2011).

<sup>24</sup> For example, "Criminal litigation will continue without interruption as an activity essential to the safety of human life and the protection of property," and employees are to "process all immigration cases and appeals involving detained aliens, including criminal aliens." Moreover, "all operations of the FBI are directed toward national security and investigations of violations of law involving protection of life and property" and are therefore permitted under the emergency exception. Dept. of Justice, *2011 Contingency Plan* (Apr. 7, 2011) 3, 5, 9 available at <http://www.justice.gov/jmd/publications/2011-doj-contingency-plan.pdf> (last visited Dec. 21, 2011).

<sup>25</sup> Dept. of Justice, *2011 Contingency Plan* (Apr. 7, 2011), 7 available at <http://www.justice.gov/jmd/publications/2011-doj-contingency-plan.pdf> (last visited Dec. 21, 2011).

**EXPLANATION OF RECOMMENDATION**

The IRS, during an appropriations lapse, should be able to assist taxpayers whose lives or property may be jeopardized if the IRS does not perform its functions such as issuing refunds, releasing liens and levies, and returning levy proceeds. Clarifying that the emergency exception permits the IRS to protect taxpayer life and property better aligns with other federal agencies' approach. Failing this, IRC § 7811 should be clarified to provide that the National Taxpayer Advocate's authority to issue TAOs continues during a lapse in appropriations and includes the authority to incur obligations in advance of appropriations, and that the IRS has the authority to incur obligations in advance of appropriations to comply with any TAOs. This would ensure that TAS would have enough employees working to provide immediate emergency assistance to taxpayers, and that the IRS would have sufficient staff to handle TAS's requests for help.

LR  
#9**Assessment of Civil Penalties Against Preparers of Fraudulent Returns****PROBLEM**

There is a small segment of the tax return preparer community who defraud taxpayers and the IRS by altering the taxpayers' returns without their knowledge. A number of these cases involved fraudulent schemes in which paid return preparers completed and taxpayers signed correct tax returns that claimed refunds, but which the preparers then altered without the taxpayers' knowledge to claim increased refunds that the taxpayers were not entitled to receive.<sup>1</sup> The preparers filed the altered returns with the IRS, which either remitted the entire inflated refunds to the preparers, who then wire transferred the amounts the taxpayers were expecting into each taxpayer's bank account (*i.e.*, the amounts shown on the correct returns), or split the refund between the preparer's and taxpayer's bank accounts, as indicated on the return.<sup>2</sup>

In such cases, the IRS later discovers that the taxpayer is not entitled to all of the refund claimed on the filed return, but does not know that the return was altered without the taxpayer's knowledge. The IRS therefore attempts to retrieve the excess refund from the unsuspecting taxpayer. There needs to be a sizeable monetary penalty to discourage return preparers from engaging in this type of behavior.

**EXAMPLE**

A taxpayer is due a refund of \$350. After completing a return that claims the refund and shows no income tax liability, and giving the taxpayer a copy, the preparer alters the return before filing it electronically. He inflates the taxpayer's income and credit for withholding to show a liability of \$500 and withholding of \$3,850, increasing the refund to \$3,350. The preparer designates his own bank account to receive \$3,000 as a direct deposit, and the taxpayer's account to receive \$350. The taxpayer receives the refund she was expecting and is entitled to, while the preparer fraudulently takes \$3,000 without her knowledge.

The IRS assesses the \$500 liability on the filed return but on later review finds the taxpayer is only entitled to \$350 in credits instead of the \$3,850 shown, leaving a \$150 balance due. It therefore seeks to recover the entire \$3,350 refund from the taxpayer, as well as the \$150 liability it believes she owes. The taxpayer responds that she only claimed \$350 in credits and had no liability due. She provides the IRS with a copy of the return that the preparer

<sup>1</sup> Through fiscal year 2011, TAS had approximately 140 alleged preparer fraud cases open. TAS, 2011 Refund Fraud CTA Case Referrals (on file with the Taxpayer Advocate Service). For a detailed discussion of the IRS's failure to implement procedures providing relief to taxpayers who are victims of preparer fraud, see *Most Serious Problem: Tax-Related Identity Theft Continues to Impose Significant Burdens on Taxpayers and the IRS*, *supra*. See also Proposed Taxpayer Advocate Directive (TAD) 2011-1 (June 13, 2011).

<sup>2</sup> Internal Revenue Code (IRC) § 6402(a) provides that the IRS shall refund any overpayment of tax to the person who made the overpayment. IRS Form 8888, *Allocation of Refund (Including Savings Bond Purchases)*, allows a taxpayer to specify up to three different accounts into which a refund can be direct-deposited.

had provided to her, which is the return she intended to file. The IRS then accepts that copy as her original return, and agrees she was entitled to a refund of \$350. Yet the government has lost revenue of \$3,000 (the amount the preparer fraudulently obtained), which cannot be collected from the preparer through administrative means because it is not a tax liability of the preparer.

## 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.

## PRESENT LAW

### **A return altered by a preparer without the taxpayer's consent is not a valid return.**

In general, there is a four-part test (often referred to as the *Beard*<sup>3</sup> test or substantial compliance standard) for determining whether a document is a valid tax return: “First, there must be sufficient data to calculate tax liability; second, the document must purport to be a return; third, there must be an honest and reasonable attempt to satisfy the requirements of the tax law; and fourth, the taxpayer must execute the return under penalties of perjury.”<sup>4</sup>

The *Beard* requirement to sign a return under penalties of perjury derives from Internal Revenue Code section 6065, which provides that generally, any return, declaration, statement, or other document required to be made under any provision of the internal revenue laws or regulations shall contain or be verified by a written declaration that it is made under penalties of perjury. The purpose of this requirement is to authenticate the signed document, and to verify its truthfulness. A return that does not comply with section 6065 fails the fourth prong of the *Beard* test. The requirement under *Beard* that a return be executed under penalties of perjury is absolute.<sup>5</sup> Signing the jurat included on a Form 1040 or Form 8879,<sup>6</sup> for electronically filed tax returns, satisfies the requirement that the return is executed under the penalties of perjury.

In cases in which the taxpayer is unaware of a tax return preparer's fraudulent alteration of items of income, deductions, credits, or withholding after the taxpayer signed the tax return (or the Form 8879), the taxpayer has not executed the document under penalties of perjury. Thus, the return the preparer filed with the IRS is not the taxpayer's return, and

<sup>3</sup> *Beard v. Comm'r*, 82 T.C. 766 (1984), *aff'd per curiam*, 793 F.2d 139 (6th Cir. 1986).

<sup>4</sup> *Beard*, 82 T.C. at 777.

<sup>5</sup> See, e.g., *Hettig v. United States*, 845 F.2d 794 (8th Cir. 1988); *United States v. Moore*, 627 F.2d 830, 834 (7th Cir. 1980) (citations omitted).

<sup>6</sup> Form 8879, *IRS e-file Signature Authorization*, is the declaration document that a taxpayer must sign under penalties of perjury, reflecting that he or she has reviewed a copy of the return that the preparer will be filing electronically.

does not meet the Beard test. Consequently, that return is invalid. The IRS Office of Chief Counsel (Counsel) has concurred with this interpretation, and has advised that the taxpayer should submit his or her true original return upon discovering the fraudulent actions of the preparer.<sup>7</sup> Moreover, Counsel has advised that the IRS should adjust the taxpayer's account to remove all entries attributable to the purported return filed by the preparer.<sup>8</sup>

**The IRS has limited remedies for penalizing a preparer who commits fraud against a taxpayer, and for recouping a taxpayer's refund that was diverted inappropriately into the preparer's bank account.**

The IRS has limited authority to recoup an erroneous refund<sup>9</sup> from a preparer who has defrauded the taxpayer and the government. Because the funds the preparer received by virtue of his fraudulent actions are not a tax liability that the preparer owes, the IRS cannot administratively recover those funds using erroneous refund procedures.<sup>10</sup> Instead, the IRS's only remedy to recover the refund is to request the Department of Justice (DOJ) to file a civil action, but only if the Attorney General authorizes the filing of a suit and recovers the erroneous refund on behalf of the United States.<sup>11</sup> Such litigation, however, is costly to the government, particularly in low-dollar amount cases.

Internal Revenue Code section 6695(f) imposes a \$500 penalty on a preparer who negotiates a taxpayer's refund check.<sup>12</sup> In regulations promulgated under section 6695(f), the IRS and Treasury have interpreted the penalty to apply to a preparer who negotiates "a check (including an electronic version of a check."<sup>13</sup> Nothing in the preamble to those regulations, however, makes clear that "electronic version of a check" is the same as direct deposit. Thus, arguably the section 6695(f) penalty is not applicable to a preparer who diverts a taxpayer's refund via direct deposit into the preparer's bank account.

The IRS may impose a civil penalty of 20 percent of the amount in excess of an allowable claim for credit or refund where there is no reasonable basis for the claim.<sup>14</sup> In addition,

<sup>7</sup> PMTA 2011-20, *Tax Return Preparer's Alteration of a Return* (June 27, 2011); PMTA 2011-13, *Horse's Tax Service* (May 12, 2003).

<sup>8</sup> IRS, Office of Chief Counsel, POSTN-145098-08, *Refunds Improperly Directed to a Preparer* (Dec. 17, 2008).

<sup>9</sup> An "erroneous refund" is defined as the receipt of any payment from the IRS to which the recipient is not entitled. IRM 21.4.5.1(2) (Oct. 1, 2006).

<sup>10</sup> Although the refund remitted to the preparer's bank account is an erroneous refund within the meaning of IRC § 7405, the government is unable to use assessment procedures to administratively collect that refund against the preparer, as the amount is not a tax liability of the preparer. See IRM 21.4.5 (Sept. 16, 2011). The IRS can, however, request that the Department of Justice file an erroneous refund suit against the preparer. See IRM 34.6.2.7 (Aug. 11, 2004).

<sup>11</sup> IRC § 7401 generally prohibits any civil action for the recovery or collection of taxes unless authorized by the Secretary of the Treasury, or his or her delegate, and directed by the Attorney General, or his or her delegate. IRC § 7405 provides that an erroneous refund may be collected by filing a civil suit brought in the name of the United States. The suit must be filed within five years of the erroneous refund if it appears that any part of the refund was induced by fraud or misrepresentation of a material fact as provided by IRC § 6532(b).

<sup>12</sup> Similarly, section 10.31 of Circular 230 (31 C.F.R. Part 10) prohibits a tax practitioner who prepares tax returns from endorsing or negotiating a client's federal tax refund check.

<sup>13</sup> Treas. Reg. § 1.6695-1(f)(1).

<sup>14</sup> IRC § 6676 applies to any person making a claim, not specifically the taxpayer, and is only available if a penalty under Part II of Chapter 68A does not apply. IRC § 6664(b) provides that penalties under Part II of Chapter 68A (e.g., section 6662) only apply where a valid return is filed. Thus, if the taxpayer can prove the return filed by the preparer is not a valid return, the section 6662 accuracy-related penalty is not applicable, and therefore the IRS could apply the section 6676 penalty.

a preparer penalty of \$50 per return for failing to furnish a copy of the filed return may apply,<sup>15</sup> or a penalty of the greater of \$5,000 or 50 percent of the income derived by the preparer for willful or reckless understatement of liability may apply.<sup>16</sup> The IRS can also ask the DOJ to seek an injunction or criminal penalties in court.<sup>17</sup>

### REASONS FOR CHANGE

While the IRS may request that the DOJ seek court action to collect erroneous refunds, such litigation is costly to the government, particularly in low-dollar amount cases. Moreover, if the document filed by the preparer is not a valid return under the *Beard* test, many of the penalties applicable to preparers are not available, because they require a valid return to trigger liability. In addition, even if the IRS is able to assert a penalty (*e.g.*, section 6695(f) for diverting a taxpayer's refund via direct deposit), the amount of the penalty is generally far below the amount received by the preparer. Thus, the currently available remedies fall short in fully recovering the erroneous fraudulent refund, and may not adequately deter preparers from engaging in fraud.

### EXPLANATION OF RECOMMENDATION

The recommendation permits the IRS to assert a penalty equal to 100 percent of any refund obtained by a preparer through the fraudulent alteration of a taxpayer's return without the taxpayer's knowledge. Such a penalty would be consistent with the IRS's policy on penalties; penalties are to be used to enhance compliance and deter inappropriate conduct.<sup>18</sup> Moreover, consistent with other civil penalties involving fraudulent activity, the IRS should have the burden of proof with respect to the penalty.

<sup>15</sup> IRC § 6695(a).

<sup>16</sup> IRC § 6694(b), providing that the preparer must be a tax return preparer who "prepares any return or claim for refund with...an understatement of liability... [in] (A) a willful attempt in any manner to understate the liability for tax on the return or claim, or (B) a reckless or intentional disregard of rules or regulations."

<sup>17</sup> IRC § 7407 permits the DOJ to file a civil action to enjoin any tax return preparer from further engaging in willful or reckless conduct in preparation of a return, failing to provide a copy of the filed return to the taxpayer, or any conduct subject to a criminal penalty. IRC § 7207 imposes a fine of not more than \$10,000 and imprisonment of not more than a year, or both for submission of a false or fraudulent return.

<sup>18</sup> See Policy Statement 20-1 (Formerly P-1-18), IRM 1.2.20.1.1 (June 29, 2004).

LR  
#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**

When an organization's exempt status under Internal Revenue Code (IRC) § 501(c)(3) is revoked, the organization becomes subject to tax and its donors can no longer deduct their contributions. Administrative appeal rights generally allow exempt organizations (EOs) to contest revocation.<sup>1</sup> 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 returns for three consecutive years.<sup>2</sup> The PPA does not prohibit administrative review of an IRS conclusion that an organization's exempt status was automatically revoked. However, the IRS declines to provide such a review, instead advising taxpayers to simply contact the IRS in the event of a dispute, or to apply for reinstatement.<sup>3</sup>

The PPA does not prescribe any particular IRS form to apply for reinstatement as an IRC § 501(c)(3) organization. However, 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*, which the IRS estimates takes *more than two weeks* to complete.<sup>4</sup> Small charities, which constitute the majority of the "revoked" organizations, could provide sufficient information on a shorter "Form 1023-EZ" if the IRS made one available.<sup>5</sup>

The user fee for filing Form 1023 is usually \$400 for organizations with gross receipts of \$10,000 or less and \$850 for those with gross receipts in excess of \$10,000.<sup>6</sup> In 2009, taxpayers were informed that if they prepared Form 1023 using Cyber Assistant, a web-based software program that the IRS is developing, they would pay only \$200, a savings of either

<sup>1</sup> Rev. Proc. 2011-9, 2011-2 I.R.B. 283, secs. 12 and 7 (Jan. 10, 2011).

<sup>2</sup> See IR-2011-63, *IRS Identifies Organizations that Have Lost Tax Exempt Status; Announces Special Steps to Help Revoked Organizations* (June 8, 2011), available at <http://www.irs.gov/newsroom/article/0,,id=240239,00.html?portlet=7>; Pension Protection Act of 2006, Pub. L. No. 109-280 § 1223, 120 Stat. 780, 1090 (2006). For a detailed discussion of automatic revocation of tax-exempt status, see Most Serious Problem: *The IRS Makes Reinstatement Following Automatic Revocation of Exempt Status Unnecessarily Burdensome*, *supra*.

<sup>3</sup> See, e.g., Automatic Exemption Revocation for Non-Filing: Frequently Asked Questions, available at <http://www.irs.gov/charities/article/0,,id=237750,00.html> and at <http://www.irs.gov/charities/article/0,,id=241119,00.html>.

<sup>4</sup> IRS Instructions for Form 1023 at 24. The estimated time for completing the main form, consisting of Parts I-XI, includes estimated times for recordkeeping (89 hours, 26 minutes), learning about the law or the form (five hours, ten minutes), preparing the form (nine hours, 39 minutes), copying and assembling the form, and sending it to the IRS (48 minutes). In addition to completing Parts I-XI, taxpayers may be required to submit one or more of Schedules A-H. The IRS estimates each of Schedules A-H takes on average more than ten hours to complete, including recordkeeping, learning about the law or the form, preparing the form, and copying, assembling and sending the form to the IRS. See Most Serious Problem: *The IRS Makes Reinstatement Following Automatic Revocation of Exempt Status Unnecessarily Burdensome*, *supra*.

<sup>5</sup> Of the "revoked" organizations for whom information is available, most were public charities that had last reported revenue of less than \$25,000. See Most Serious Problem: *The IRS Makes Reinstatement Following Automatic Revocation of Exempt Status Unnecessarily Burdensome*, *supra*.

<sup>6</sup> Rev. Proc. 2011-8, 2011-1 I.R.B. 237 (Jan. 3, 2011). Organizations eligible for transitional relief may submit their reinstatement application by Dec. 31, 2012, for a reduced user fee of \$100. See Notice 2011-43, 2011-25 I.R.B. 882 (June 9, 2011); Rev. Proc. 2011-36, 2011-25 I.R.B. 915 (June 9, 2011).

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50 percent or 76 percent over the usual user fee.<sup>7</sup> Cyber Assistant will not replace the paper application form, which the applicant will still print and mail to the IRS, but it will help applicants avoid making errors or leaving mandatory sections of the form incomplete, an improvement that will benefit taxpayers and the IRS. For most EOs, particularly those in their first year of operation, for whom every penny counts, using an additional \$650 for program services rather than as an IRS user fee is an important opportunity. Some EOs may have even delayed filing their Forms 1023, preferring to wait for the reduced user fee and increased efficiency Cyber Assistant would bring.<sup>8</sup> However, the release of Cyber Assistant has been delayed until further notice.<sup>9</sup>

### EXAMPLE

Generally, a parent exempt organization files “group returns” on behalf of subordinate chapters, relieving them of a separate filing requirement.<sup>10</sup> An incoming officer, uninformed that the chapter already had an employer identification number (EIN) that appeared on the group return, obtained a duplicate number. Unable to associate the second EIN with the group return, the IRS assumed that the chapter did not meet the applicable requirement and listed it as automatically revoked for failure to file for three years in a row. According to IRS materials on revoked subordinates, “if an organization’s tax-exempt status is revoked for failure to file for three years, the only way it can get that status reinstated is to apply for exemption.”<sup>11</sup> No administrative review process is available or publicized to straighten out this factual misunderstanding.

### RECOMMENDATIONS

The National Taxpayer Advocate recommends that Congress:

1. Require the IRS to allow administrative review of its conclusion that an organization’s exempt status was automatically revoked.
2. Require the IRS to develop a Form 1023-EZ.
3. Require and provide sufficient funding for the IRS to implement Cyber Assistant for use in preparing applications for recognition of exempt status.

<sup>7</sup> See IRS Notice 1382 (Rev. Sept. 2009) advising taxpayers that Cyber Assistant would become available in 2010 and the user fee for applications prepared using Cyber Assistant would be \$200.

<sup>8</sup> See Brian Cave Charitable Group, *Patience Is a Virtue – and Can Also Save Money* (Oct. 19, 2010), available at <http://bryancavecharitylaw.com/patience-is-a-virtue-and-can-also-save-you-money/> (advising readers that “A major advantage of the cyber assistant will be a significant reduction in the application fee...As 2010 winds down, newly formed charities may want to delay filing the Form 1023 application until the cyber assistant is available”).

<sup>9</sup> Internal Revenue Manual (IRM) 3.45.1.10.6.2 (Mar. 29, 2011), available at <http://serp.enterprise.irs.gov/databases/irm.dr/current/3.dr/3.45.dr/3.45.1.dr/3.45.1.10.6.2.htm>.

<sup>10</sup> Instructions for Form 990 Return of Organization Exempt From Income Tax (2010), Appdx. E; see also Brian Tumulty, *IRS Still Trying to Weed Out Defunct Non-profits*, USA Today (June 28, 2011).

<sup>11</sup> FAQ 26 at <http://www.irs.gov/charities/article/0,,id=241119,00.html> (last visited Oct. 24, 2011).

## CURRENT LAW

The PPA imposed a new annual filing requirement on small exempt organizations (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.<sup>12</sup> The purpose of the new filing requirement is to ensure that the IRS can maintain a reliable record of small EOs' continuing existence, that the public can easily obtain basic information about an organization, such as its current address, and that the IRS will know when to omit EOs from its published list of organizations to which charitable contributions may be made.<sup>13</sup> Judicial review of automatic revocations is not available, but the PPA does not prohibit administrative review of the IRS's conclusion that an EO's exempt status was revoked.<sup>14</sup> The statute requires organizations whose exempt status was automatically revoked to apply for reinstatement, but does not specify the precise method for making the application.<sup>15</sup>

## REASONS FOR CHANGE

The consequences of revocation may be severe, yet there is no mechanism for an organization to obtain review of a claim that the IRS erred in concluding that its exempt status was automatically revoked. EOs that consult the IRS website for more information may simply be advised to apply for reinstatement. The application for reinstatement is Form 1023, the same form used to request initial recognition of exempt status. The IRS estimates the form takes more than two weeks to complete.<sup>16</sup> The checklist alone that lists all the documents taxpayers must submit with the form is over a page long.<sup>17</sup> Moreover, the IRS has not articulated how it plans to use the information it obtains from the Forms 1023 filed by EOs seeking reinstatement.<sup>18</sup>

Small EOs may qualify for transitional relief that allows them to submit Form 1023 by December 31, 2012, for a reduced user fee of \$100.<sup>19</sup> Otherwise, the fee for filing Form 1023 is \$400 for EOs with gross receipts of \$10,000 or less and \$850 for those with gross receipts of over \$10,000.<sup>20</sup> In 2009, the IRS advised the public that Cyber Assistant would be available in 2010 and the user fee for Forms 1023 prepared using Cyber Assistant would be \$200, regardless of the size of the organization.<sup>21</sup> Some EOs had to decide whether

<sup>12</sup> Pension Protection Act of 2006, Pub. L. No. 109-280 § 1223, 120 Stat. 780, 1090 (2006). The \$25,000 threshold is now \$50,000. Rev. Proc. 2011-15, 2011-3 I.R.B. 322.

<sup>13</sup> See S. Rep. No. 109-336 (2006) 41, accompanying S. 1321, The Telephone Excise Tax Repeal and Taxpayer Protection and Assistance Act of 2006, Tit. III, W. Notification Requirement for Exempt Entities Not Currently Required to File an Annual Information Return.

<sup>14</sup> IRC § 7428(b)(4).

<sup>15</sup> IRC § 6033(j)(2).

<sup>16</sup> IRS Instructions for Form 1023 at 24.

<sup>17</sup> IRS Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, 27-28.

<sup>18</sup> See Most Serious Problem: *The IRS Makes Reinstatement of an Organization's Exempt Status Following Automatic Revocation Unnecessarily Burdensome*, *supra*.

<sup>19</sup> See Rev. Proc. 2011-36, 2011-25 I.R.B. 915 (June 20, 2011).

<sup>20</sup> Rev. Proc. 2011-8, 2011-1 I.R.B. 237 (Jan. 3, 2011).

<sup>21</sup> IRS Notice 1382 (Rev. Sept. 2009).

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to file the Form 1023 in 2009 or wait for the advent of Cyber Assistant.<sup>22</sup> The IRS then announced, in May 2010, that the release of Cyber Assistant would be delayed until 2011.<sup>23</sup> The uncertainty has now been resolved for 2011 because Cyber Assistant is not yet available and the IRS does not know when it will be ready.<sup>24</sup> Therefore, EOs can now expect to spend \$200 or \$650 more on an IRS user fee that might have been applied to direct program services.

### EXPLANATION OF RECOMMENDATION

Requiring the IRS to afford administrative review of automatic revocations merely recognizes that the IRS may err in concluding that an organization is no longer exempt. Taxpayers should have means of obtaining relief when that error occurs, rather than being required to reapply for recognition of exempt status. Although the IRS may provide such reviews on an ad hoc basis, standards of tax administration and administrative procedure dictate that the IRS should establish and make public the process for EOs to request a review.

Requiring the IRS to develop a Form 1023-EZ would lessen taxpayer burden without depriving the IRS of any information it currently tracks or uses. Providing funding for and requiring the IRS to implement Cyber Assistant would improve the accuracy and consistency of applications, thereby conserving resources for taxpayers and the IRS. The reduced user fee is especially important to these taxpayers, especially in this economy, because it would free resources that could be used for EOs' direct program services. Both a Form 1023-EZ and Cyber Assistant would make it easier for EOs to remain compliant with their reporting obligations.

<sup>22</sup> See, e.g., the Hodgen Law Group PC blog (Nov. 10, 2009), available at <http://hodgen.com/irs-cyber-assistant-professional-fees-evaporate/> ("Hmmm... Here's my problem...I have to decide whether or not to go ahead and file before the 3rd of Jan, which more than likely would cost me \$850 (although I fear I might be misunderstanding their 4 year \$10,000 guideline)...or...do I wait, use whatever money I have now to put into the organization, and just wait for the Cyber Assistant to come around, which would save me \$600???").

<sup>23</sup> See Grant Williams, *IRS Announces Delay in New Tool for Groups Seeking Charity Status*, Chronicle of Philanthropy, May 17, 2010, available at <http://philanthropy.com/blogs/government-and-politics/irs-announces-delay-in-new-tool-for-groups-seeking-charity-status/24007>.

<sup>24</sup> IRM 3.45.1.10.6.2 (Mar. 29, 2011), available at <http://serp.enterprise.irs.gov/databases/irm.dr/current/3.dr/3.45.dr/3.45.1.dr/3.45.1.10.6.2.htm>. Rev. Proc. 2011-8, 2011-1 I.R.B. 237, sec. 2.06 (Jan. 3, 2011) states "The references...to application fees after Cyber Assistant availability have been removed because the Service does not expect Cyber Assistant...to become available in 2011."

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

For millions of U.S. taxpayers living abroad, the measurement of U.S. taxable income may be complicated and distorted when those taxpayers receive wages and other income or pay expenses in a foreign currency.<sup>1</sup> Current law requires taxpayers to make all federal income tax determinations in their functional currencies.<sup>2</sup> Generally, individual U.S. taxpayers must use the U.S. dollar as their functional currency.<sup>3</sup> This requirement raises two problems.

First, taxpayers receiving payments in a foreign currency must translate into dollars all the income they receive and all the deductible expenses they pay in the foreign currency, using the prevailing exchange rate as of the date each item of income or expense is paid, received, or accrued.<sup>4</sup> Second, currency fluctuations may create capital gains even on routine personal transactions.<sup>5</sup>

Individual U.S. taxpayers abroad are not afforded the flexibility currently extended to U.S. businesses, whose foreign branches may use the currencies of the countries where their business units are conducting economic activities, but can elect the U.S. dollar as a functional currency if certain criteria are met.<sup>6</sup> Individuals may be confused by the multitude and volatility of exchange rates and are subject to the additional burdens of properly substantiating these rates, tracking the basis of acquired foreign currency, and making multiple calculations for U.S. tax purposes, which may differ from the tax determinations they make in local currency for their country of residence.<sup>7</sup>

<sup>1</sup> An estimated five million to seven million U.S. citizens reside abroad. IRS, *Reaching Out to Americans Abroad* (Apr. 2009), <http://www.irs.gov/businesses/article/0,,id=205889,00.html>; W&I Research Study Report, *Understanding the International Taxpayer Experience: Service Awareness, Use, Preferences, and Filing Behaviors* (Feb. 2010) (citing U.S. Department of State data). This number does not include U.S. troops stationed abroad.

<sup>2</sup> Internal Revenue Code (IRC) § 985; Treas. Reg. § 1.985-1. Prior to 1986, the IRC did not contain express statutory rules for determining the character, amount, and timing of exchange gains or losses arising from fluctuations in the value of foreign currency. See Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

<sup>3</sup> IRC § 985; Treas. Reg. § 1.985-1(b).

<sup>4</sup> The IRS does not have official exchange rates and generally accepts any posted exchange rate that is used consistently. The IRS website refers to three government and three external resources for exchange rates. See IRS, *Foreign Currency and Currency Exchange Rates*, <http://www.irs.gov/businesses/small/article/0,,id=130524,00.html> (last visited Sept. 25, 2011).

<sup>5</sup> See generally IRC §§ 988; 1001; 1011-1023; Treas. Reg. § 1.988-2; Rev. Rul. 74-7, 1974-1 C.B. 198.

<sup>6</sup> Qualified business units (QBUs) of U.S. businesses are required to use the currency of the economic environment where a significant part of QBU activities are conducted as their functional currency, provided the QBU keeps its books and records in that currency. IRC §§ 985(b), 989; Treas. Reg. §§ 1.985-1, 1.989(a)-1. A QBU that would be required to use a hyperinflationary currency as its functional currency may elect to use the U.S. dollar as a functional currency if certain criteria are met. See generally IRC §§ 985(b)(3); Treas. Reg. § 1.985-3.

<sup>7</sup> For example, the IRS website contains a link to an external site ([www.oanda.com](http://www.oanda.com)) as a source of historic currency exchange rates that provides 11 different types of rates (and three additional sub-rates within these rates) by date and a selling and a buying exchange rate for each date. See, e.g., OANDA website, <http://www.oanda.com/currency/converter/> (last visited Sept. 23, 2011). It is unclear how many taxpayers observe these rules. There is no evidence that the IRS strictly enforces them.

Verifying multiple exchange-rate computations for personal transactions and substantiation of spot exchange rates at the time the transaction took place in an IRS audit makes the administration of these provisions extremely difficult.<sup>8</sup> It precludes the IRS from undertaking any reasonable or effective compliance initiative in this area.

Requiring individual U.S. taxpayers residing in a foreign country to use the U.S. dollar as their functional currency creates confusion and uncertainty, makes compliance difficult, and places an unnecessary administrative burden on the IRS.<sup>9</sup>

### EXAMPLE

A married couple, H and W, are U.S. citizens and *bona fide* residents of country A. H works for a branch of a U.S. corporation in the country and W is employed by a local business. Both are paid in local currency (LC).

Each year, H and W file returns and pay taxes in country A. They maintain their records and calculate their income for tax reporting purposes in country A in LC and convert these amounts to U.S. dollars solely to compute their U.S. tax liability. This means they have to research exchange rates for each transaction and make tax determinations in dollars. Although H and W spend hundreds of hours computing their income and expenses in dollars, they are not sure if they have used a correct exchange rate because of the multitude and volatility of rates. If the IRS audits their returns, it would need to verify the conversion of all items of income and deductible expenses into dollars, creating a significant commitment of time and resources for its Examination function.

### RECOMMENDATION

The National Taxpayer Advocate recommends that Congress amend Internal Revenue Code (IRC) § 985 to allow individual U.S. taxpayers residing abroad:

1. 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
2. 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.

<sup>8</sup> The spot rate is generally the rate reflecting a fair market rate of exchange available to the public under a spot contract in a free market and involving representative amounts. A spot contract is a contract to buy or sell nonfunctional currency on or before two business days following the execution of the contract. See Treas. Reg. § 1.988-1(b) and (d).

<sup>9</sup> See National Taxpayer Advocate 2009 Annual Report to Congress 139.

## PRESENT LAW

IRC § 985(a) generally requires that all income tax determinations (*e.g.*, computations of taxable income or loss) be made in a taxpayer's functional currency.<sup>10</sup> A taxpayer's functional currency is the dollar, except in the case of a qualified business unit that conducts a significant part of its activities in an economic environment with a different currency and keeps its books and records in that currency.<sup>11</sup> A QBU is a separate, clearly identified unit of a trade or business of a taxpayer that maintains separate books and records.<sup>12</sup> A QBU is generally required to use the currency of the economic environment in which a significant part of that QBU's activities are conducted and which that QBU uses in keeping its books and records.<sup>13</sup> Generally, such a QBU will compute income or loss in its functional currency, converting the overall results of its operations for a taxable year into U.S. dollars to report on the U.S. tax return at the end of the year, using the average exchange rate for the taxable year.<sup>14</sup> A QBU that would be required to use a hyperinflationary currency as its functional currency may elect to use the U.S. dollar as a functional currency if certain criteria are met.<sup>15</sup>

An individual is not a QBU.<sup>16</sup> Therefore, individual U.S. taxpayers' functional currency is the U.S. dollar. Any such taxpayers receiving payments in a foreign currency must translate into dollars all the income they receive and all the deductible expenses they pay in foreign currency, using the prevailing exchange rate as of the date each item of income or expense is paid, received, or accrued.<sup>17</sup> Although an individual is not a QBU, an individual may have a QBU if it conducts activities constituting a trade or business and maintains a separate set of books and records with respect to those activities.<sup>18</sup> An individual's activities as an employee do not constitute a trade or business for these purposes.<sup>19</sup>

As a general rule, the receipt or payment of an amount denominated in a currency other than the functional currency of the taxpayer is treated as the acquisition or disposition of

<sup>10</sup> IRC § 985(a); Treas. Reg. § 1.985-1(a). The QBU must keep its books and records in that currency.

<sup>11</sup> IRC § 985(b); Treas. Reg. § 1.985-1(b).

<sup>12</sup> IRC § 989(a); Treas. Reg. § 1.989(a)-1.

<sup>13</sup> IRC § 985(b); Treas. Reg. §§ 1.985-1(c); 1.985-3.

<sup>14</sup> See *generally* IRC § 987. Under proposed section 987 regulations issued in 2006, depreciation must be translated at the historic exchange rate when the asset was purchased. Under the proposed section 987 regulations issued in 2006, currency gain or loss on the QBU's financial assets is taken into account when the QBU makes a remittance of property to the owner of the QBU.

<sup>15</sup> See *generally* IRC § 985(b)(3); Treas. Reg. § 1.985-3.

<sup>16</sup> Treas. Reg. § 1.989-1(b)(2). Although an individual may have a QBU that uses a non-dollar functional currency, an activity that does not generate deductible expenses under either IRC §§ 162 or 212 does not qualify as a QBU. Treas. Reg. § 1.989(a)-1(b) and (c). Therefore, an individual cannot have a QBU based on activities that do not constitute a trade or business, typically including an individual's activities as an employee. Treas. Reg. § 1.989(a)-1(b)(2)(ii) and (c).

<sup>17</sup> IRC § 985; Treas. Reg. § 1.985-1.

<sup>18</sup> Treas. Reg. § 1.989(a)-1(b)(2)(ii).

<sup>19</sup> Treas. Reg. § 1.989(a)-1(c).

property.<sup>20</sup> Exchange gain from the disposition of nonfunctional currency is the excess of the amount realized over the adjusted basis of the currency, and exchange loss is the excess of the adjusted basis of the currency over the amount realized.<sup>21</sup> Upon the disposition of a nonfunctional currency, a taxpayer generally must recognize gain or loss resulting from fluctuations in exchange rates that have occurred since the taxpayer acquired that currency.<sup>22</sup> This foreign currency gain or loss is calculated separately from any gain or loss on the underlying transaction and is treated as ordinary gain or loss.<sup>23</sup> Exchange gain of an individual of \$200 or less on the disposition of nonfunctional currency in a personal transaction is not recognized.<sup>24</sup> Individuals are not allowed a deduction for losses resulting from the devaluation of a foreign currency in a personal transaction.<sup>25</sup>

For the purposes of determining the source of foreign currency gain or loss, the residence of an individual U.S. citizen or resident alien is the country in which such individual's tax home is located.<sup>26</sup>

## REASONS FOR CHANGE

Although individual U.S. taxpayers residing abroad may calculate their foreign income tax liability in a foreign currency, they must use the U.S. dollar as a functional currency and translate all income and expense items denominated in foreign currency into dollars as of the date such income and expenses are paid, received, or accrued solely to compute their U.S. tax liabilities.<sup>27</sup> Because foreign currency is property for federal tax purposes, taxpayers must track the basis of foreign currency received. For any individual, this is challenging.

<sup>20</sup> Nonfunctional currency is considered to be "property" for U.S. federal tax purposes. IRC §§ 988; 1001(b); 1011-1023; Treas. Reg. § 1.988-2(a)(1)(i). See also *Philip Morris Inc. v. Comm'r*, 71 F.3d 1040 (2d Cir. 1995), *aff'g* 104 T.C. 61 (1995); *National-Standard Company v. Comm'r*, 749 F.2d 369 (6th Cir. 1984), *aff'g* 80 T.C. 551 (1983); Rev. Rul. 74-7, 1974-1 C.B. 198.

<sup>21</sup> Treas. Reg. § 1.988-2(a)(2)(ii)(A). Generally, gain or loss from the disposition of nonfunctional currency is treated as ordinary income or loss. See IRC § 988(a)(1). Individuals' nonfunctional currency gains or losses arising from "personal transactions" are not subject to section 988, and thus are subject to general timing, source, and character rules of the IRC. See H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess., at II-669 (1986); S. Rep. No. 313, 99th Cong., 2d Sess., at 469 (1986). Gains on certain *de minimis* personal transactions are excludable entirely. See footnote 25.

<sup>22</sup> See generally IRC § 988(c)(1)(C).

<sup>23</sup> IRC § 988(a). Treas. Reg. § 1.988-1(a)(1). For discussion of the separate transaction principle, see, e.g., *Helburn v. Comm'r*, 214 F.2d 815 (1st Cir. 1954); *Church's English Shoes, Ltd., v. Comm'r*, 24 T.C. 56 (1955), *aff'd, per curiam* 229 F.2d 957 (2nd Cir. 1956); Rev. Rul. 78-281, 1978-2 C.B. 204.

<sup>24</sup> The term "personal transaction" means any transaction that does not result in a deductible trade or business expense under IRC § 162 (including an individual's currency exchange transactions that are entered into in connection with business travel) or an expense incurred in the production of income under IRC § 212 (other than expenses incurred in connection with taxes). See IRC § 988(e)(3).

<sup>25</sup> IRC § 165(c) limits the loss deduction for individuals to losses incurred in a trade or business, losses incurred in any transaction entered into for profit, and casualty losses. See also H. Rep. 105-148, 105th Cong., 1st Sess., at 263, 447-448 (1997).

<sup>26</sup> See generally IRC §§ 988(a)(3); 911(d)(3). The term "tax home" has the same meaning which it has for purposes of IRC § 162(a)(2) (relating to travel expenses away from home) and is considered to be located at an individual's regular or principal (if more than one regular) place of business or, if the individual has no regular or principal place of business because of the nature of the business, then at his or her regular place of abode in a real and substantial sense. IRC § 911(d)(3); Treas. Reg. § 1.911-2(b).

<sup>27</sup> The IRS does not have official exchange rates and generally accepts any posted exchange rate that is used consistently. The IRS's website refers to three government and three external resources for currency exchange rates. See IRS, *Foreign Currency and Currency Exchange Rates*, <http://www.irs.gov/businesses/small/article/0,,id=130524,00.html> (last visited Sept. 25, 2011).

Additionally, for many U.S. taxpayers abroad, the disposition of any foreign currency resulting in a gain of \$200 or more is a recognition event, meaning that many of those individuals' routine transactions (for example, paying rent) in foreign currency can give rise to taxable gain.<sup>28</sup> Because exchange gains in excess of \$200 are taxable while exchange losses cannot offset gains on personal transactions, determining certain individuals' U.S. tax liabilities in dollars (when their financial results are calculated in a foreign currency) can yield distorted results, especially in years of currency volatility.<sup>29</sup>

The IRC § 988(e) exclusion passed in 1997 (as part of the Taxpayer Relief Act of 1997) was intended to simplify reporting by individual taxpayers and eliminate an individual's obligation to compute and report gains arising from exchanges of currency that are *de minimis* in amount and are associated with personal transactions.<sup>30</sup> However, the legislation did not achieve that goal. To determine whether the gain from any disposition of nonfunctional currency is \$200 or less and therefore is not recognized under the exclusion, individual taxpayers must first compute the gain on each transaction separately. These multiple computations are burdensome for taxpayers as well as being difficult and time-consuming for IRS auditors to verify. Without allowing individual U.S. taxpayers to elect the currency of their country of residence as the functional currency, the goal of eliminating multiple foreign exchange computations associated with personal, nonbusiness activities cannot be practically achieved.

From a tax administration perspective, these rules require IRS audits to verify multiple exchange rate computations for personal transactions and substantiate spot exchange rates at the time the transaction took place, which could be very labor-intensive and inefficient. The sheer complexity of converting every personal expenditure into U.S. currency makes it all but impossible for the IRS to undertake any reasonable or effective compliance initiative in this area.

<sup>28</sup> For example, when a U.S. citizen residing in Canada receives a monthly salary of CA\$3000 on July 15 of a taxable year, she must first convert CA\$3000 into U.S. dollars at the spot rate of .95 \$ for CA\$ on the 15th of July, meaning that each CA\$ has a basis of 95 U.S. cents. Then when she pays rent of CA\$1500 on August 1 of a taxable year, it is treated as a disposition of foreign currency (assuming that the taxpayer can determine the basis of the exact amount in foreign currency). If the exchange rate on August 1 is \$1.1 per CA\$, she realizes and must recognize a taxable exchange gain of \$225 as the difference between the U.S. dollar basis in the currency (CA\$1500 \* .95 = \$1425) and the U.S. dollar amount realized (CA\$1500 \* 1.1 = \$1650). However, if the change in exchange rates results in a loss, such a loss is personal and therefore nondeductible.

<sup>29</sup> For some taxpayers, gain or loss can arise simply because of changes in foreign currency values, which may not represent a net gain or loss for the taxpayer. These gains are taxable, while losses on these transactions are nondeductible because the transactions are personal.

<sup>30</sup> See Pub. L. No. 105-34, 111 Stat. 788 (1997). See also H. Rep. 105-148, 105th Cong., 1st Sess., at 263, 447-448 (1997) ("Reasons for Change. An individual who lives or travels abroad generally cannot use U.S. dollars to make all of the purchases incident to daily life. If an individual must treat foreign currency in this instance as property giving rise to U.S.-dollar income or loss every time the individual, in effect, barter the foreign currency for goods or services, the U.S. individual living in or visiting a foreign country will have a significant administrative burden that may bear little or no relation to whether U.S.-dollar measured income has increased or decreased. The Committee believes that individuals should be given relief from the requirement to keep track of exchange gains on a transaction-by-transaction basis in *de minimis* cases.").

As a result, current functional currency rules applicable to individual U.S. taxpayers abroad discourage voluntary compliance, are difficult to administer, and unnecessarily burden both taxpayers and the IRS.<sup>31</sup>

## EXPLANATION OF RECOMMENDATION

The National Taxpayer Advocate recommends applying rules similar to the QBU rules to individuals with respect to personal activities occurring in the foreign country in which a U.S. person is a *bona fide* resident (as defined in IRC § 911(d)(1)).<sup>32</sup> Under this legislative proposal, individual U.S. taxpayers resident in a foreign country would be permitted to elect the local currency as their functional currency with respect to certain activities associated with their residence in that country (*e.g.*, activities of a qualified residence unit or QRU). Qualified QRU activities would include most personal, nonbusiness transactions associated with a taxpayer's *bona fide* residence in a foreign country. Permitting individual taxpayers to elect a foreign currency as a functional currency of the QRU would allow them to receive and spend the foreign currency on routine personal transactions without potentially triggering gain on each transaction. Taxpayers also could aggregate all their transactions in a foreign currency and use a single exchange rate (generally, the average rate for the year) to translate their income, including the realized currency gain (if any), annually.

The proposed legislative change would not alter the current treatment of certain investment and other financial transactions of individual U.S. taxpayers abroad set forth in IRC § 988.<sup>33</sup> However, there are certain policy concerns for Congress' consideration. Under current rules, investments of U.S. taxpayers abroad, such as a purchase and disposition of a primary residence or retirement savings, may result in a gain which may not represent a net gain for the taxpayer.<sup>34</sup> For example, fluctuations in exchange rates can lead to instances in which a taxpayer realizes taxable gain on the sale of a residence, but may not offset

<sup>31</sup> Groups of American citizens abroad have long advocated for the change in the functional currency rules for *bona fide* U.S. residents abroad. See, *e.g.*, *The Burdens Imposed by the Current Federal Income Tax System and the Need for Reform, Hearing Before the H. Comm. on Ways and Means, 112th Cong.* (statement of American Citizens Abroad (ACA), the Association of Americans Resident Overseas (AARO), and the Federation of American Women's Clubs, Inc. (FAWCO)); The Association of Americans Resident Overseas, *Legislative Proposals for Tax Reform Concerning U.S. Citizens Residing Abroad*, <http://www.aaro.org/proposals-for-tax-reform> (last visited Sept. 25, 2011). See also Overseas Americans Week 2011, <http://www.overseasamericansweek.com> (last visited Sept. 25, 2011).

<sup>32</sup> This change would not add complexity because current law requires these individuals to satisfy the *bona fide* residence test or the physical presence test to claim the foreign earned income exclusion. To qualify for foreign earned income exclusion and foreign housing exclusion or deduction, a U.S. citizen or resident alien (for tax purposes) must have a tax home in a foreign country, and either be a *bona fide* resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year (*bona fide* residence test), or be present in a foreign country or countries during at least 330 full days in any period of 12 consecutive months (physical presence test). IRC § 911(d).

<sup>33</sup> See, *e.g.*, legislative history underlying IRC § 988 which indicates that § 988 rules were designed to address, *inter alia*, "opportunities for tax-motivated transactions involving certain financial assets or liabilities that are denominated in a nonfunctional currency." See S. Rep. No. 313, 99th Cong., 2d Sess., at 450 (1986); General Explanation of the Tax Reform Act of 1986 (Pub. L. No. 99-514) JCS-10-87, Pt. 3, Title XII, at 1091 (1987).

<sup>34</sup> From a taxpayers' perspective, currency gains as a result of certain investment transactions are "phantom" (*i.e.*, not representing an actual economic gain). For example, a married couple, H and W, are U.S. citizens and *bona fide* residents of country A. In taxable year (TY) 2009, a married couple had to liquidate some assets because of a family medical emergency. The couple decided to sell 100 shares of XYZ Company stock that they purchased for LC 10,000 in September 2000. Given the exchange rate on the date of purchase of \$0.865 to LC 1, the stock was worth \$8,650. The couple sells the stock in March 2010 for LC 9,600, which is worth approximately \$14,650 (at the exchange rate of \$1.525 to LC 1), resulting in an actual or economic loss of LC 400, and a taxable gain of \$6,000 for U.S. tax purposes. They do not exchange the funds into dollars or any other currency.

losses on a related mortgage under the personal loss disallowance rules.<sup>35</sup> The National Taxpayer Advocate recommends that Congress take into account these concerns when considering the legislation for “benign” U.S. taxpayers residing abroad who do not invest in or trade foreign currency or move abroad to exempt gains and losses from such investment activities resulting from currency fluctuations.<sup>36</sup>

Under this proposal, we recommend that Congress continue to grant the IRS broad regulatory authority in this area and, if a new statutory provision is enacted, further authorize the Secretary to prescribe regulations to address offsetting gains and losses on personal mortgages and related foreign-currency denominated mortgages.<sup>37</sup>

Allowing an individual U.S. taxpayer living abroad the option of using the currency of the country of residence for tax purposes would facilitate both compliance with and administration of U.S. tax laws, and would produce results based on economic reality rather than the arbitrary movement of exchange rates. This legislative change will simplify record-keeping and computations, decrease distortions of economic gain or loss for tax purposes, and therefore increase voluntary compliance and public trust in the fairness of the U.S. tax system.

<sup>35</sup> See IRC § 165(c); see also *Quijano v. U.S.*, 93 F.3d 26 (1st Cir. 1996), and Rev. Rul. 90-79, 1990-2 C.B. 187 (both holding that an individual U.S. citizen residing in a foreign country could not offset the gain realized from the sale of a personal residence with a loss realized from the repayment of a nonfunctional currency denominated mortgage loan used to finance the purchase of the residence). Please note that the instances in which non-economic gains are taxable only occur in specific cases, e.g., the sale of a leveraged personal asset or the sale of investments to fund personal expenses.

<sup>36</sup> For example, an individual U.S. taxpayer living in Switzerland could generally determine his wages and deductible expenses in Swiss francs and translate these items at the average exchange rate for the year. However, if that individual invested in Swiss franc-denominated bonds or other financial instruments, IRC § 988 would continue to apply to such investments. A difficult question would be how to treat Swiss francs invested in checking and savings accounts. A U.S. taxpayer will realize real economic currency gains and losses from such accounts and the amounts deposited may be substantial. One approach would be to establish a threshold at which currency movements on amounts deposited in a bank would be taxable.

<sup>37</sup> See IRC § 989(c). The legislative recommendation would not necessarily reverse the result in *Quijano* and Rev. Rul. 90-79. See *Quijano*, 93 F.3d 26 (1st Cir. 1996); Rev. Rul. 90-79, 1990-2 C.B. 187.

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#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 required to assist taxpayers in resolving problems with the IRS, to identify areas in which taxpayers have frequent problems or that are the frequent subject of litigation, and to identify administrative and legislative solutions to reduce controversy and mitigate such problems.<sup>1</sup> Despite these mandates, the mission of the Office of the Taxpayer Advocate would be advanced by additional statutory authority in three areas: *amicus curiae* briefs pertaining to taxpayer rights; the administrative rulemaking process; and the Taxpayer Advocate Directive.

#### Authority to File *Amicus Curiae* Briefs Pertaining to Taxpayer Rights

The National Taxpayer Advocate is not authorized to participate in litigation.<sup>2</sup> While the conduct of relevant trials themselves may be best left to trial lawyers equipped to advocate zealously on behalf of individual clients, precedential issues of interest to numerous taxpayers may come before the judiciary with no one representing the rights of taxpayers in general.

#### Authority to Comment on Regulations and the Requirement of IRS Response

Another form of problem resolution is the drafting of guidance on controversial or complex issues. The IRS often issues rules and regulations to illuminate tax law complexities. In the case of published guidance, the IRS Office of Chief Counsel and the Department of the Treasury prepare and circulate drafts internally for cross-divisional commentary.<sup>3</sup> When the IRS and Treasury promulgate tax regulations, the public has an opportunity to comment at a hearing and in writing prior to finalization of the regulations.<sup>4</sup> These internal and external processes may yield productive commentary, especially from interested parties, industry associations, institutional constituencies, or the professional bar. Although

<sup>1</sup> Internal Revenue Code (IRC) § 7803(c)(2)(A)(i)-(iv).

<sup>2</sup> See 28 U.S.C. § 516 (“Except as otherwise authorized by law, the conduct of litigation in which the United States, an agency, or officer thereof is a party, or is interested, and securing evidence therefor, is reserved to officers of the Department of Justice”); 5 U.S.C. § 3106 (“Except as otherwise authorized by law, the head of an Executive department or military department may not employ an attorney or counsel for the conduct of litigation in which the United States, an agency, or employee thereof is a party”); IRC § 7452 (indicating that the Secretary of the Treasury “shall be represented by the Chief Counsel”).

<sup>3</sup> IRC § 7803(b)(2) (indicating that the Chief Counsel is the chief law officer for the IRS); see *generally* Treas. Reg. § 601.601.

<sup>4</sup> Generally, the Admin. Proc. Act (APA) requires public notice and opportunity to comment on regulatory rule-making except for, *inter alia*, interpretative rules. 5 U.S.C. § 553. According to IRS Chief Counsel Directives Man. (CCDM) 32.1.1.2.6(1) (Sept. 23, 2011): “Most IRS/Treasury regulations are considered interpretative because the underlying statute implemented by the regulation contains the necessary legal authority for the action taken and any effect of the regulation flows directly from that statute.” Nevertheless, “the Service usually solicits public comment when it promulgates a rule.” CCDM 32.1.5.4.7.5.1(3) (Sept. 30, 2011). According to an academic commentator, “the opposite is true. . . . under general principles of administrative law, it is difficult to characterize most Treasury regulations as anything other than legislative rules subject to the notice-and-comment rulemaking requirements of APA § 553(b) and (c) and ineligible for the interpretative rule, procedural rule, or good cause exceptions from those procedures.” Kristin E. Hickman, *A Problem of Remedy: Responding to Treasury’s (Lack of) Compliance with Administrative Procedure Act Rulemaking Requirements*, 76 GEO. WASH. L. REV. 1153, 1158 (2008).

the National Taxpayer Advocate is charged with representing the interests of individuals, including low income taxpayers, there is no statutory requirement that the IRS address the National Taxpayer Advocate's comments before publishing final regulations. In the case of the Small Business Administration (SBA), the Chief Counsel for Advocacy has statutory authority to represent the interests of small businesses by appearing as *amicus curiae*<sup>5</sup> and providing comments that the IRS must consider before publishing any final regulation.<sup>6</sup>

### The Authority to Issue a Taxpayer Advocate Directive

In the course of assisting taxpayers in resolving problems or identifying areas in which taxpayers have problems in dealing with the IRS, the National Taxpayer Advocate from time to time confronts procedural obstacles. In such cases, the Commissioner of Internal Revenue has delegated to the National Taxpayer Advocate the authority to issue Taxpayer Advocate Directives that direct IRS units to change procedures "to improve the operation of a functional process or to grant relief to groups of taxpayers (or all taxpayers) when implementation will protect the rights of taxpayers, prevent undue burden, ensure equitable treatment, or provide an essential service to taxpayers."<sup>7</sup> However, the IRS may not comply with or even respond to a Taxpayer Advocate Directive because it comes not under a statute but merely a delegated power that the Commissioner could revoke. In practice, the Commissioner or Deputy Commissioner, along with the National Taxpayer Advocate, may rescind or modify a Taxpayer Advocate Directive.<sup>8</sup>

## EXAMPLES

### Innocent Spouse Relief

In 2000, two years after a substantial amendment of the innocent spouse statute, which generally affords relief from the tax liability of a joint filer,<sup>9</sup> the IRS prescribed applicable procedures through sub-regulatory guidance.<sup>10</sup> In 2001, the IRS incorporated a two-year limit on claims for equitable relief into proposed regulations,<sup>11</sup> duly finalized the next year after a notice and comment procedure.<sup>12</sup> No comments on this limitation were received or entered the published record.

After the regulation took effect, it became evident to innocent spouses and their representatives that the limitation impeded otherwise meritorious claims. In 2006 and 2010, the National Taxpayer Advocate called attention to the issue through published recommenda-

<sup>5</sup> 5 U.S.C. § 612(b).

<sup>6</sup> IRC § 7805(f).

<sup>7</sup> Delegation Order 13-3 (formerly DO-250, Rev. 1), *reprinted as* IRM 1.2.50.4 (Jan. 17, 2001); see also IRM 13.2.1.6 (July 16, 2009).

<sup>8</sup> Delegation Order 13-3 (formerly DO-250, Rev. 1), *reprinted as* IRM 1.2.50.4 (Jan. 17, 2001).

<sup>9</sup> See IRC § 6015 (relating to relief from joint and several liability) *added by* Pub. L. No. 105-206, § 3201 (1998).

<sup>10</sup> See Rev. Proc. 2000-15, 2000-1 C.B. 447, *superseded by* Rev. Proc. 2003-61, 2003-2 C.B. 296 (containing parallel provisions).

<sup>11</sup> Relief from Joint and Several Liability, 66 Fed. Reg. 3,888 (proposed Jan. 17, 2001).

<sup>12</sup> See Treas. Reg. § 1.6015-5(b)(1), 67 Fed. Reg. 47,294 (July 18, 2002).

tions to remove the regulatory period of limitation.<sup>13</sup> Meanwhile, the Tax Court invalidated the regulatory limitation, only to spawn protracted litigation in multiple circuits of the Courts of Appeals, which reversed the Tax Court and upheld the validity of the regulation.<sup>14</sup> In the 2010 Annual Report to Congress, the National Taxpayer Advocate published a comprehensive analysis of the legislative history for Internal Revenue Code (IRC) § 6015(f), which could not be submitted as an *amicus* brief in pending appellate litigation under present law.<sup>15</sup> After urging by numerous Senators and Representatives,<sup>16</sup> the Commissioner reviewed the regulation and decided to rescind the two-year rule.<sup>17</sup>

### Timely Mailing and Filing

In general, timely mailing by taxpayers constitutes timely filing with the IRS.<sup>18</sup> Specifically, a registered or certified mail receipt is *prima facie* evidence of delivery on the postmark date.<sup>19</sup> Over the years, a split in the circuits has developed concerning this rule. Some circuits have allowed taxpayers to present evidence of mailing other than a registered or certified mail receipt.<sup>20</sup> Other circuits have excluded extrinsic evidence.<sup>21</sup> In 2004, the IRS issued a proposed regulation stating that a registered or certified mail receipt is the exclusive *prima facie* evidence, other than direct proof of actual delivery.<sup>22</sup> The National Taxpayer Advocate informally offered oral and written comments that the statute supplements, rather than supplants, a taxpayer's right to present evidence; limiting the presumption to registered or certified mail creates a foot-fault when some other mailings may have been timely. Without acknowledging the National Taxpayer Advocate's comments in the preamble, the IRS finalized the regulation in 2011.<sup>23</sup>

### Adjustment of Accounts for Victims of Return Preparer Fraud

The National Taxpayer Advocate issued a Proposed Taxpayer Advocate Directive to the Commissioner of the IRS Wage and Investment (W&I) operating division, ordering him to issue guidance and implement a procedure for adjusting the accounts of taxpayers who had

<sup>13</sup> National Taxpayer Advocate 2006 Annual Report to Congress 540 (Legislative Recommendation: *Eliminate the Two-Year Limitation Period for Taxpayers Seeking Equitable Relief Under IRC § 6015 or IRC § 66*); National Taxpayer Advocate 2010 Annual Report to Congress 377 (Legislative Recommendation: *Allow Taxpayers to Request Equitable Relief Under Internal Revenue Code Section 6015(f) or 66(c) at any Time Before Expiration of the Period of Limitations on Collection and to Raise Innocent Spouse Relief as a Defense in Collection Actions*).

<sup>14</sup> See *Lantz v. Comm'r*, 132 T.C. 131 (2009), *rev'd and remanded*, 607 F.3d 479 (7th Cir. 2010); *Mannella v. Comm'r*, 132 T.C. 196 (2009), *rev'd*, 631 F.3d 115 (3d Cir. 2011); *Jones v. Comm'r*, T.C. Docket No. 17359-08, *rev'd and remanded*, 642 F.3d 459 (4th Cir. 2011).

<sup>15</sup> National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 1 (Research Study: *Unlimit Innocent Spouse Equitable Relief*).

<sup>16</sup> See 2011 TNT 75-27, 75-28 (Apr. 19, 2011).

<sup>17</sup> IRS News Release, *Two-Year Limit No Longer Applies to Many Innocent Spouse Requests*, IR-2011-80 (July 25, 2011).

<sup>18</sup> IRC § 7502(a).

<sup>19</sup> IRC § 7502(c); Treas. Reg. § 301.7502-1(c)(2).

<sup>20</sup> See, e.g., *Estate of Wood v. Comm'r*, 909 F.2d 1155 (8th Cir. 1990), *aff'g* 92 T.C. 793 (1989), *action on dec.*, 1991-024 (Oct. 22, 1991).

<sup>21</sup> See, e.g., *Deutsch v. Comm'r*, 599 F.2d 44 (2d Cir. 1979), *cert. denied*, 444 U.S. 1015 (1980).

<sup>22</sup> *Timely Mailing Treated as Timely Filing*, 69 Fed. Reg. 56,377 (proposed Sept. 21, 2004).

<sup>23</sup> T.D. 9543, 76 Fed. Reg. 52,561 (Aug. 23, 2011). It is currently the practice of the IRS to discuss substantive external comments in the preamble. Many internal stakeholders, including the National Taxpayer Advocate, may offer comments, none of which are discussed in the preamble. See CCDM 32.1.8.3(1) (Aug. 11, 2004).

been victimized by return preparers.<sup>24</sup> The W&I Commissioner failed to respond timely to the Proposed Taxpayer Advocate Directive, and the problem remains unresolved.<sup>25</sup>

## RECOMMENDATION

To enhance the independence of the Office of the Taxpayer Advocate and ensure that the rights of taxpayers, including the most vulnerable and unrepresented, are considered and protected in tax administration, regulations, and litigation, the National Taxpayer Advocate recommends that Congress:<sup>26</sup>

1. Authorize the National Taxpayer Advocate to submit *amicus curiae* briefs in federal appellate litigation on matters relating to the protection of taxpayer rights that the National Taxpayer Advocate has identified as concerns in her Annual Reports to Congress.
2. Require the IRS to submit proposed or temporary regulations pre-publication to the National Taxpayer Advocate for comment within a reasonable time, and address those comments in the preamble to final regulations.
3. Authorize the National Taxpayer Advocate to appoint an independent counsel who reports directly to the National Taxpayer Advocate, to provide independent legal advice, including submission of *amicus curiae* briefs and comments on proposed or temporary regulations.
4. Grant to the National Taxpayer Advocate nondelegable authority to issue a Taxpayer Advocate Directive 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, and require that, to object to a directive, the IRS would have to respond timely in writing.<sup>27</sup>
5. Amend IRC § 7811 to require the IRS to raise its objections to a Taxpayer Assistance Order (*i.e.*, appeal the Order) issued by the National Taxpayer Advocate by responding in writing within a reasonable time, as established by the National Taxpayer Advocate in the Order.

## PRESENT LAW

Congress established the position of Chief Counsel, a Senate-confirmed official who reports to the Treasury General Counsel regarding tax policy, but to the Commissioner of Internal

<sup>24</sup> Proposed TAD 2011-1 (June 13, 2011). See also Most Serious Problem: *Tax-Related Identity Theft Continues to Impose Significant Burdens on Taxpayers and the IRS*, *supra*; Legislative Recommendation: *Assessment of Civil Penalties Against Preparers of Fraudulent Returns*, *supra*.

<sup>25</sup> The Dep. Comm'r (Services and Enforcement) wrote to the National Taxpayer Advocate on Sept. 2, 2011, that the IRS is "in the process of developing procedures to adjust taxpayers' accounts where the taxpayer never received a refund or portion of a refund due to preparer fraud and appropriate documentation has been submitted."

<sup>26</sup> Previously, the National Taxpayer Advocate has recommended legislation for *amicus* briefs and independent counsel. See National Taxpayer Advocate 2002 Annual Report to Congress 198-215 (Legislative Recommendation: *Office of the Taxpayer Advocate*).

<sup>27</sup> Previously, a recommendation to codify Taxpayer Advocate Directives appeared in National Taxpayer Advocate 2002 Annual Report to Congress 198.

Revenue and the Treasury General Counsel with respect to legal advice or interpretation of the tax law not relating solely to tax policy.<sup>28</sup> The Office of Chief Counsel is the legal advisor to the IRS, furnishing legal opinions, preparing Treasury Regulations, representing the IRS in the United States Tax Court, and preparing recommendations for the Department of Justice regarding which civil tax litigation to pursue.<sup>29</sup>

The IRS issues rules and regulations,<sup>30</sup> which the Office of Chief Counsel circulates internally for comment (to the National Taxpayer Advocate as well as other IRS functions)<sup>31</sup> prior to submission to Treasury for review and approval. The IRS publishes proposed regulations in the *Federal Register*, creating an opportunity for public comment. The tax law specifically requires that after publication, the IRS must submit proposed and temporary regulations to the Chief Counsel for Advocacy of the SBA for comment, and the Chief Counsel for Advocacy must provide comments, if any, within four weeks; the IRS is then required to respond to the comments in the preamble to the final regulation.<sup>32</sup> After reviewing comments, the IRS finalizes regulations for incorporation into the Code of Federal Regulations.

Chief Counsel attorneys are assigned to the Office of the Special Counsel (National Taxpayer Advocate Program).<sup>33</sup> In addition, the Office of the Taxpayer Advocate has hired lawyers who do not report to the Chief Counsel.<sup>34</sup> These lawyers prepare legislative recommendations for the National Taxpayer Advocate, render advice to the National Taxpayer Advocate in cases in which TAS is advocating for the taxpayer vis-à-vis the IRS, represent the National Taxpayer Advocate in meetings with the Office of Chief Counsel and the IRS, and assist in drafting Reports to Congress and congressional testimony.

The SBA's Chief Counsel for Advocacy has statutory authority to submit *amicus* briefs.<sup>35</sup> That Counsel's primary responsibility is to oversee federal compliance with the Regulatory Flexibility Act, which seeks to forestall any rules that impose unnecessary burdens on the public.<sup>36</sup> A small business or other entity that is adversely affected or aggrieved by final government action may be entitled to judicial review, which can result in remand of a regulation for corrective action by the issuing agency and deferral of enforcement against small entities.<sup>37</sup> In any such litigation, the Chief Counsel for Advocacy is authorized to present

<sup>28</sup> IRC § 7803(b)(3).

<sup>29</sup> IRC § 7803(b)(2).

<sup>30</sup> IRC § 7805(a).

<sup>31</sup> CCDM 32.1.6.7.2(2) (Aug. 11, 2004).

<sup>32</sup> IRC § 7805(f); see also *Jt. Comm. on Tax'n, Description of Small Business Tax Incentive Act of 1990*, JCX-40-90 (Oct. 15, 1990) 5.

<sup>33</sup> IRC § 7803(b)(4).

<sup>34</sup> See H.R. Conf. Rep. No. 105-599, 105th Cong. 2d Sess., at 216 (June 24, 1998) (discussed *infra*). Other IRS lawyers outside of the Office of Chief Counsel include those in the Office of Professional Responsibility and estate tax lawyers in the SB/SE Operating Division.

<sup>35</sup> 5 U.S.C. § 612(b).

<sup>36</sup> Pub. L. No. 96-354, § 2(a)(1), 94 Stat. 1164, 1170 (Sept. 19, 1980) (findings codified at 5 U.S.C. § 601); 5 U.S.C. § 612(a) (duties of SBA Chief Counsel for Advocacy). Like the National Taxpayer Advocate, the Chief Counsel for Advocacy submits reports to Congress at least annually. *Id.*

<sup>37</sup> 5 U.S.C. § 611.

views regarding compliance with the Act, the adequacy of the rule-making record with respect to small entities, and the effect of rules on small entities.<sup>38</sup> While the Department of Justice initially questioned the constitutionality of this authority, such questions have subsided, and more recently, the Chief Counsel for Advocacy has filed *amicus* briefs judiciously and successfully.<sup>39</sup>

As cited above, a delegation order and internal guidance govern Taxpayer Advocate Directives. Where a previous request to change a process or grant relief has been to no avail, the Commissioner of Internal Revenue has delegated authority to the National Taxpayer Advocate (but not her delegate) to issue a Taxpayer Advocate Directive to protect taxpayer rights, ensure equitable treatment, or provide an essential service.<sup>40</sup> An IRS division commissioner or other executive may appeal a Taxpayer Advocate Directive to the Deputy Commissioner (Services and Enforcement).<sup>41</sup>

By contrast, the Internal Revenue Code explicitly authorizes the National Taxpayer Advocate (or her delegate) to issue a Taxpayer Assistance Order if a taxpayer may suffer significant hardship because of the IRS's manner of tax administration.<sup>42</sup> A Taxpayer Assistance Order may require the IRS to release levied property or to cease, take, or refrain from any action under specified law.<sup>43</sup> The Commissioner or Deputy Commissioner may rescind or modify a Taxpayer Assistance Order upon delivering a written explanation to the National Taxpayer Advocate.<sup>44</sup> The National Taxpayer Advocate is authorized by statute to establish the timeframes within which such actions or responses must occur.<sup>45</sup>

## REASONS FOR CHANGE

### Authority to File *Amicus Curiae* Briefs Pertaining to Taxpayer Rights

As in the case of the SBA Chief Counsel for Advocacy, there is good reason to allow the federal judiciary to hear the perspective of the National Taxpayer Advocate — an independent advocate for taxpayer rights and fair tax administration. By its nature, this perspective may diverge from that of the IRS, and would not necessarily be endorsed by the actual taxpayers who are embroiled in specific litigation, where circumstances rather than principles

<sup>38</sup> 5 U.S.C. § 612(b) (authorizing *amicus* briefs).

<sup>39</sup> At one time, the Department of Justice opposed an SBA brief on the ground that the provision granting the Chief Counsel for Advocacy the authority to act as *amicus curiae* violated the Constitution. This led to withdrawal of the brief, but the Congressional Research Service (CRS) later concluded the authority was constitutional. H. R. Rept. No. 104-49, Appdx. D at 3-4 (Feb. 23, 1995) (discussing the opposition to the brief, but attaching a CRS report concluding that the *amicus* authority was constitutional). The Chief Counsel for Advocacy has since filed at least five more *amicus* briefs, which appear to have been successful in prompting Government concessions without challenge on constitutional grounds. See SBA, *Background Paper on the Office of Advocacy 2001-2008* (Oct. 2008) 40-41.

<sup>40</sup> IRM 13.2.1.6(3) (July 16, 2009).

<sup>41</sup> IRM 13.2.1.6.2 (July 16, 2009).

<sup>42</sup> IRC § 7811(a), (f).

<sup>43</sup> IRC § 7811(b).

<sup>44</sup> IRC § 7811(c).

<sup>45</sup> IRC § 7811(b).

may induce settlement. Precisely for this reason, Congress has seen fit to establish the Office of the Taxpayer Advocate, whose mandate could be facilitated by an independent counsel function extending to the submission of *amicus* briefs on behalf of the National Taxpayer Advocate in precedential cases in which taxpayer rights might not otherwise be represented.

#### **Authority to Comment on Regulations and the Requirement of IRS Response**

Also as in the case of the SBA Chief Counsel for Advocacy, there is good reason to mandate review of proposed and temporary IRS regulations. In general, public comment improves rule-making by allowing recommendations and observations from experts with knowledge outside of government. A robust comment process justifies judicial deference to regulations that have benefited from external review.<sup>46</sup> Where interested parties, industry associations, or tax law professionals offer analysis of proposed regulations, the notice-and-comment process is successful. On the other hand, some taxpayer interests are not represented by sophisticated tax professionals. In the case of small businesses, Congress recognized this need by legislatively mandating regulatory review on their behalf by a counsel dedicated to this function. The rights of individual taxpayers, including low income taxpayers, may fall in a gap in regulatory review. While the National Taxpayer Advocate is often included in pre-publication circulation of proposed or temporary regulations, the IRS is not required to address her comments in the published preambles to final regulations. The National Taxpayer Advocate believes that tax administration would be improved if the public knew what her concerns were with respect to regulations and how the IRS addressed those concerns.

#### **The Authority to Issue a Taxpayer Advocate Directive**

Finally, the National Taxpayer Advocate's ability to create systemic change remains incomplete without statutory authority to issue Taxpayer Advocate Directives. The judicial and regulatory recommendations above complement existing authority for legislative proposals. While current law guarantees protection of taxpayer rights under a Taxpayer Assistance Order in an individual case, no law ensures that a Taxpayer Advocate Directive redressing a flawed process — which could harm entire taxpayer populations — will be honored, timely acted upon, or even acknowledged by the IRS.

### **EXPLANATION OF RECOMMENDATION**

The National Taxpayer Advocate, who is mandated to report annually to Congress on frequently litigated tax issues and serious taxpayer problems, may comment on issues developing in the courts, but has no authority to submit her independent perspective to the

<sup>46</sup> See *Long Island Care at Home, Ltd. v. Coke*, 551 U.S. 158, 173-74 (2007) (citation omitted) (stating “where the agency uses full notice-and-comment procedures to promulgate a rule, . . . then a court ordinarily assumes that Congress intended it to defer to the agency’s determination.”).

judiciary.<sup>47</sup> Likewise, the National Taxpayer Advocate may identify issues and offer comments to the Office of Chief Counsel on taxpayer rights during the drafting of a regulation, but has no statutorily mandated process for review on behalf of individual taxpayers. If the Office of Chief Counsel circulates proposed rules through the IRS, the Special Counsel (National Taxpayer Advocate Program) coordinates the distribution of drafts to the National Taxpayer Advocate and her subject matter experts. Although the IRS's practice is to circulate all guidance to the National Taxpayer Advocate for comment prior to publication,<sup>48</sup> the law should provide for mandated review by the National Taxpayer Advocate. As with the review process for regulations submitted to the SBA Chief Counsel for Advocacy,<sup>49</sup> the IRS should be required to respond to TAS comments in the preamble to the final regulation.

When Congress reorganized the IRS in 1998, the Senate passed legislation providing for counsel to the National Taxpayer Advocate to be appointed by and report directly to the National Taxpayer Advocate and to operate within the Office of the Taxpayer Advocate.<sup>50</sup> In sponsoring this provision, Senator Charles Grassley (R-Iowa) offered the following rationale:

The purpose of doing this is to give the Taxpayer Advocate ready access to legal opinions and legal judgments. Currently, the Taxpayer Advocate must put requests into the Office of Chief Counsel.

In order to make the Taxpayer Advocate more independent, which is what this bill does, it logically follows that the Taxpayer Advocate should have its own legal counsel. This will guarantee it fast, confidential legal advice to help those taxpayers in greatest need. Because it is the taxpayers in greatest need who go to the Taxpayer Advocate.<sup>51</sup>

This provision was eliminated in the conference agreement. Still, the conference report noted that the "conferees intend that the National Taxpayer Advocate be able to hire and consult counsel as appropriate."<sup>52</sup>

Although the National Taxpayer Advocate has hired lawyers, she does not have the authority to file *amicus* briefs. While the National Taxpayer Advocate, or her attorneys, may comment informally on rule-making from time to time, the IRS is not required by law to notify the National Taxpayer Advocate of proposed or temporary regulations or to respond to her comments before publishing final regulations. By statutorily requiring the IRS (1) to provide the National Taxpayer Advocate with proposed and temporary regulations prior to

<sup>47</sup> See Program Manager Tech. Assistance 00566, *Authority for the National Taxpayer Advocate to File Amicus Briefs with the Courts of the United States* (Oct. 2, 2002).

<sup>48</sup> See CCDM 32.1.6.7.2(2) (Aug. 11, 2004).

<sup>49</sup> IRC § 7805(f)(2).

<sup>50</sup> H.R. Conf. Rep. No. 105-599, 105th Cong. 2d Sess., at 215 (June 24, 1998).

<sup>51</sup> 144 CONG. REC. S4460 (May 7, 1998) (statement of Sen. Grassley).

<sup>52</sup> H.R. Conf. Rep. No. 105-599, 105th Cong. 2d Sess., at 216 (June 24, 1998).

publication, and (2) to formally address the National Taxpayer Advocate's concerns in the preamble to final regulations, Congress and the taxpaying public can confirm that taxpayer rights concerns are addressed in the rulemaking process.

Further, in a case where the National Taxpayer Advocate adopts a position that diverges from that of the IRS, the official position of Chief Counsel attorneys is that of the IRS.<sup>53</sup> Because the National Taxpayer Advocate is authorized by law to advocate for change, which often is in conflict with the official position of the IRS, this reporting structure can impair a Chief Counsel attorney's ability to zealously represent the interests of the National Taxpayer Advocate. Moreover, a Chief Counsel attorney would not be able to submit an *amicus curiae* brief on behalf of the National Taxpayer Advocate if such brief were in conflict with the position of the IRS. Thus, providing the National Taxpayer Advocate the statutory authority to appoint an independent Counsel to the National Taxpayer Advocate, reporting to the National Taxpayer Advocate and not to the Chief Counsel, would help ensure that the National Taxpayer Advocate's concerns about protection of taxpayer rights are considered and represented in the regulatory and judicial arenas.

In addition, a codified Taxpayer Advocate Directive process would enhance the National Taxpayer Advocate's ability to make systemic changes. To align the proposed authority with current Taxpayer Assistance Order law,<sup>54</sup> the recommended legislation would make the Commissioner (but not his delegate) the final arbiter when an IRS office appeals a directive. An appeal should contain a written explanation to the National Taxpayer Advocate and the Commissioner that facilitates a full and fair hearing of the issues. If an office does not appeal but simply does not respond in writing to the National Taxpayer Advocate within a reasonable time outlined in the Taxpayer Advocate Directive, then the proposed legislation would deem the IRS to have consented to making the requested systemic changes. A parallel default clause should be enacted within existing IRC § 7811 regarding Taxpayer Assistance Orders.

As under current IRC § 7811, the Commissioner could rescind or modify a Taxpayer Advocate Directive upon delivering a written explanation to the National Taxpayer Advocate. A report on rescissions by the Commissioner should be added to the National Taxpayer Advocate's annual reporting mandates.<sup>55</sup>

Together, the three components of this recommendation will enable the Office of the Taxpayer Advocate to more effectively resolve issues that are frequently litigated, further protect taxpayer rights, and deal with other recurring problems.

<sup>53</sup> See IRC § 7803(b)(4) (relating to personnel who report to the Chief Counsel).

<sup>54</sup> IRC § 7811.

<sup>55</sup> On annual reporting, see IRC § 7803(c)(2)(B).

LR  
#13**Appoint an IRS Historian****PROBLEM**

From time to time, the IRS undertakes initiatives to improve tax administration, with both successes and failures. No unit of the IRS is charged with recording these events, so any opportunity to learn from them in the future is lost. A leading academic tax historian has noted that while Publication 1694, *IRS Historical Fact Book: A Chronology, 1646-1992*, memorializes a tax timeline, “[w]e do not have a scholarly history of the Internal Revenue Service.”<sup>1</sup> 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.”<sup>2</sup> A record of IRS accomplishments is lost along with historical facts.

**EXAMPLES**

In 1984 and 1985, the IRS’s effort to transfer its massive workload to an ambitious new computer system overwhelmed management and technology. Harried front-line personnel discarded thousands of taxpayer documents — including checks — in an effort to dispose of caseload.<sup>3</sup> Although the General Accounting Office (GAO, now the Government Accountability Office) verified specific losses and confirmed IRS remedial steps, no subsequent IRS history set forth lessons learned from this episode.<sup>4</sup> While officials may have been understandably apprehensive about casting personal blame, the lesson of history rather would be to identify positive and negative precedents for the future.

More recently, the IRS piloted a pre-certification program that required Earned Income Tax Credit (EITC) claimants either to verify their eligibility for the credit before the IRS accepted their claims, or to attach documentation of eligibility to their tax returns. Ultimately, the IRS decided not to pursue pre-certification because the results of the pilot indicated that the program decreased participation in the EITC while increasing cost and burden on taxpayers.<sup>5</sup> While this conclusion may be found in various reports, no IRS historical analysis puts together the pieces, which include resistance and even litigation by residents and officials of Hartford, Connecticut, where the pilot took place.<sup>6</sup> In its perennial efforts to improve

<sup>1</sup> W. Elliot Brownlee, *Federal Taxation in America: A Short History*, 2nd ed. (Cambridge Univ. Press, 2004) 125 n. 20.

<sup>2</sup> Statement of Shelley Davis, former IRS Historian, *Practices & Procs. of the IRS*, Hearings Before the Comm. on Finance, U.S. Sen., S. Hrg. 105-190, 105th Cong. 1st Sess. (Sept. 23-25, 1997) 35.

<sup>3</sup> See GAO, *Information on IRS Service Centers in Austin, Texas and Fresno, California*, GGD-85-89 (Sept. 30, 1986); GAO, *Information on IRS Philadelphia Service Center*, GD-86-25FS (Nov. 1985).

<sup>4</sup> See Shelley L. Davis, *Unbridled Power: Inside the Secret Culture of the IRS* (NY: HarperCollins, 1997).

<sup>5</sup> See National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, at 75, 84 (Research Study: *Running Social Programs Through the Tax System*); IRS, *Earned Income Tax Credit (EITC) Initiatives, Addendum to the Report on Qualifying Child Residency, Certification, Filing Status, and Automated Underreporter Tests: Implementation of Alternative Approaches to Improving the Administration of EITC* (2008); IRS, *Earned Income Tax Credit Initiative: Final Report to Congress* (Oct. 2005).

<sup>6</sup> See Stephen D. Holt, *Keeping it in Context: Earned Income Tax Credit Compliance and Treatment of the Working Poor*, 6 Conn. Public Interest L.J. 183 (2007).

EITC compliance, the IRS may be prone to repeat attempts that could be revealed by a complete history.

### 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.

### PRESENT LAW

Generally, federal laws require retention of and access to IRS and other government records, but no law requires IRS publication of history. Under the Federal Records Act, the IRS, as a government agency, shall preserve records containing adequate and proper documentation of its organization, functions, policies, decisions, procedures, and essential transactions.<sup>7</sup> While determining what constitutes “adequate and proper documentation” could be the province of a professional historian’s judgment, the IRS delegates responsibility for compliance with record retention and related laws to a Records and Information Management program within its Real Estate and Facilities Management function.<sup>8</sup> Additionally, a Servicewide Policy, Directives, and Electronic Research (SPDER) function within the IRS Research, Analysis and Statistics division maintains an Organizational History Library documenting organizational realignments and changes in functional responsibilities of the agency.<sup>9</sup>

“In our democracy, the Freedom of Information Act (FOIA), which encourages accountability through transparency, is the most prominent expression of a profound national commitment to ensuring an open Government.”<sup>10</sup> Generally, access to federal records is governed by FOIA,<sup>11</sup> which in the IRS is administered by a Disclosure Office within the Small Business/Self-Employed division. FOIA excepts from disclosure any information protected by statute, the most notable of which in this case is Internal Revenue Code (IRC) § 6103, which generally requires that returns and return information be kept confidential.<sup>12</sup>

<sup>7</sup> 44 U.S.C. § 3101.

<sup>8</sup> See Internal Revenue Manual (IRM) 1.15.1 (Dec. 19, 2008).

<sup>9</sup> IRM 1.11.1, Exhibit 1.11.1-2 (Sept. 4, 2009), authored by SPDER, contains a description of the IRS Historical Research Library. A more specific intranet page for IRS employee access relates to Organizational History. <http://oldirm.web.irs.gov/search/orghist.asp> (last visited Oct. 17, 2011).

<sup>10</sup> Memorandum of January 21, 2009 - Transparency & Open Gov’t, 74 Fed. Reg. 4,683 (Jan. 26, 2009).

<sup>11</sup> See 5 U.S.C. § 552.

<sup>12</sup> See 5 U.S.C. § 552(b)(3).

## REASONS FOR CHANGE

Preeminent scholars have observed that while “decision-makers always draw on past experience, whether conscious of doing so or not,” the “uses now made of history can be more reflective and systematic, hence more helpful.”<sup>13</sup> Federal use of history has a venerable lineage. For example, President Franklin D. Roosevelt ordered federal agencies to record objectively the history of their activities in order to assess policy and departmental effectiveness.<sup>14</sup> During and after World War II, General Dwight D. Eisenhower supported the history programs of the armed services, employing many academically trained historians and publishing notable volumes.<sup>15</sup>

In any case, thoughtful study of history can help accomplish a mission because understanding agency origins and development aids in comprehending the present situation and illuminates possible future directions.<sup>16</sup> As exemplified above, knowledge of history can prevent the IRS from repeating past efforts that proved fruitless. History may offer the best diagnosis of breakdown in a system so complex that no single cause is to blame.<sup>17</sup>

## EXPLANATION OF RECOMMENDATION

At least 29 federal agencies, including all branches of the military and encompassing 11 Cabinet departments, employ historians.<sup>18</sup> These professionals may play roles in presenting history to the public, as in museums (Smithsonian), libraries (Library of Congress), and monuments (National Park Service). Other historians may play programmatic roles, such as uncovering evidence of war crimes or environmental damage for prosecutorial or defense offices in the Department of Justice.<sup>19</sup> Finally, some offices may conduct institutional history, in the mode of subdisciplines recognized as military or diplomatic history.

Some historians are authorized by statute, operating by law where history may be inherently controversial within the government. In particular, the custodian of federal diplomatic history is the Historian of the Department of State, who is mandated to publish “a thorough, accurate, and reliable documentary record of major United States foreign policy

<sup>13</sup> Richard E. Neustadt & Ernest R. May, *Thinking in Time: The Uses of History for Decision-Makers* (NY: Free Press, 1986) xiii, 2.

<sup>14</sup> Exec. Ord. cited by Roger D. Launius, *NASA History and the Challenge of Keeping the Contemporary Past*, 21 *Public Historian* 63 (1999).

<sup>15</sup> 21 *Public Historian* at 65.

<sup>16</sup> *Id.*

<sup>17</sup> See Chas. Perrow, *The Meltdown Was Not an Accident*, *Markets on Trial: The Economic Sociology of the U.S. Financial Crisis*, ed. Michael Lounsbury & Paul M. Hirsch, 30 *Res. in the Sociol. of Org'ns* 309 (2010); Chas. Perrow, *Normal Accidents: Living With High Risk Technologies* rev. ed. (Princeton Univ. Press, 1999); National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, *infra* (Research Study: *From Tax Collector to Fiscal Automaton: Demographic History of Federal Income Tax Administration, 1913-2011*).

<sup>18</sup> See Dir. of Fed. Hist. Ofcs. at <http://shfg.org/shfg/publications/directory-of-history-offices/> (last visited Aug. 23, 2011).

<sup>19</sup> See Eli M. Rosenbaum, *An Introduction to the Work of the Office of Special Investigations*, 54 *U.S. Attys' Bull.* 1, 4 (2006) (“A unique aspect of OSI’s operating methodology is its use of staff historians to conduct the bulk of the investigative work.”); Andrew Sorokowski, *Forensic History in Superfund Counterclaims: The CERCLA Counterclaim at the Juncture of History and Environmental Law*, 22 *Federalist: Newsltr. of Soc’y for Hist. in Fed. Gov’t* (Summer 2009) 5.

decisions and significant United States diplomatic activity.”<sup>20</sup> Moreover, this publication shall be guided by the principles of historical objectivity and accuracy. Records

shall not be altered and deletions shall not be made without indicating in the published text that a deletion has been made. The published record shall omit no facts that were of major importance in reaching a decision, and nothing shall be omitted for the purpose of concealing a defect of policy.<sup>21</sup>

Other historians recognized by statute include the Archivist who heads the National Archives and Records Administration,<sup>22</sup> and the Historians of the Senate and House of Representatives.<sup>23</sup> Statutory authorization may protect historians from dismissal when objectivity entails embarrassing facts.

History may be either promotional or critical. Popularizing the history of IRS accomplishments can be a productive aspect of civic education. On the other hand, constructive criticism in areas where the IRS can improve also may enhance tax administration in the long run even if it causes discomfort to contemporary officials. While professionals have observed that government “agencies, sometimes consciously, sometimes unknowingly, occasionally pressure history offices to use history selectively to further agency programs,” as an ethical matter, “Historians are dedicated to the truth and to full disclosure.”<sup>24</sup>

Consequently, legislation creating a position for an IRS historian should mandate objectivity as does the statute for the State Department Historian quoted above. Likewise, professional objectivity should be ensured by making the IRS historian the appointee of a subject-matter expert outside the agency. In the case of the National Taxpayer Advocate, an IRS official with access to return information under IRC § 6103, the law ensures independence by making her an appointee of the Secretary of the Treasury rather than the Commissioner of Internal Revenue.<sup>25</sup> In addition, the National Taxpayer Advocate’s mandated reports to Congress are not subject to review by the Commissioner, Secretary of the Treasury, the Oversight Board, any other officer or employee of the Department of the Treasury, or the Office of Management and Budget.<sup>26</sup>

By the same token, the IRS historian should be selected (and subject to removal) by the Secretary of the Treasury in consultation with the Archivist of the United States, the keeper of federal history, rather than the Commissioner. Day-to-day, the IRS historian nevertheless would report directly to the Commissioner, and the proposal would confirm that the his-

<sup>20</sup> 22 U.S.C. § 4351(a).

<sup>21</sup> 22 U.S.C. § 4351(b).

<sup>22</sup> See 44 U.S.C. § 2102.

<sup>23</sup> See 44 U.S.C. § 2702 added by Pub. L. No. 101-509 (1990).

<sup>24</sup> Martin Reuss, *Government and Professional Ethics: The Case of Federal Historians*, 21 *Public Historian* 135, 136 & 140 (1999).

<sup>25</sup> See IRC § 7803(c)(1)(B)(ii).

<sup>26</sup> See IRC § 7803(c)(2)(B)(iii).

torian would have access to return information as a Treasury employee. Like the National Taxpayer Advocate, whose appointment is in the control of an official outside the IRS, the historian would be subject to ultimate sanction only by the Secretary of the Treasury in consultation with the Archivist, who in turn could be the professional arbiter of objectivity in the IRS historian's reports. This protocol would relieve the Commissioner, Secretary, and President, who may have competing policy interests, from reviewing the reports before publication. This arrangement would empower the IRS historian to speak the sometimes inconvenient truth that can improve tax administration.

## Most Litigated Issues: Introduction

Internal Revenue Code (IRC) § 7803(c)(2)(B)(ii)(X) requires the National Taxpayer Advocate to identify in her Annual Report to Congress (ARC) the ten tax issues most litigated in federal courts (Most Litigated Issues).<sup>1</sup> The National Taxpayer Advocate may analyze these issues to develop recommendations to mitigate the disputes resulting in litigation.

The Taxpayer Advocate Service (TAS) identified the Most Litigated Issues from June 1, 2010, through May 31, 2011, by using commercial legal research databases. For purposes of this section of the ARC, the term “litigated” means cases in which the court issued an opinion.<sup>2</sup> This year’s Most Litigated Issues are:

- Summons enforcement (IRC §§ 7602(a), 7604(a), and § 7609(a));
- Trade or business expenses (IRC § 162(a) and related Code sections);
- Appeals from collection due process (CDP) hearings (IRC §§ 6320 and 6330);
- Failure to file penalty (IRC § 6651(a)(1)) and failure to pay estimated tax penalty (IRC § 6654);
- Gross income (IRC § 61 and related Code sections);
- Accuracy-related penalty (IRC § 6662(b)(1) and (2));
- Civil actions to enforce federal tax liens or to subject property to payment of tax (IRC § 7403);
- Relief from joint and several liability for spouses (IRC § 6015);
- Frivolous issues penalty (IRC § 6673 and related appellate-level sanctions); and
- Deduction for charitable contributions (IRC § 170).

The majority of these issues were identified as Most Litigated Issues last year, with the exception of the deduction for charitable contributions.<sup>3</sup> Summons enforcement was the top issue again this year. The number of CDP cases dropped significantly for the second year in a row—from 170 in 2009 to 131 in 2010 and 89 in 2011.<sup>4</sup> Cases with accuracy-related penalty issues decreased from 125 in 2010 to 55 in 2011, a 56 percent reduction.<sup>5</sup>

<sup>1</sup> Federal tax cases are tried in the United States Tax Court, United States District Courts, the United States Court of Federal Claims, United States Bankruptcy Courts, United States Courts of Appeals, and the United States Supreme Court.

<sup>2</sup> Many cases are resolved before the court issues an opinion. Some taxpayers reach a settlement with the IRS before trial, while the courts dismiss other taxpayers’ cases for a variety of reasons, including lack of jurisdiction and lack of prosecution. Additionally, courts can issue less formal “bench opinions,” which are not published or precedential. See *Characteristics of Earned Income Tax Credit Cases that the IRS Fully Concedes in Tax Court*, *infra*.

<sup>3</sup> See National Taxpayer Advocate 2010 Annual Report to Congress 414.

<sup>4</sup> See National Taxpayer Advocate 2010 Annual Report to Congress 416, Table 3.0.1; National Taxpayer Advocate 2009 Annual Report to Congress 405, Table 3.0.1.

<sup>5</sup> See National Taxpayer Advocate 2010 Annual Report to Congress 416, Table 3.0.1.

Once TAS identified the Most Litigated Issues, it analyzed each one in four sections: summary of findings, description of present law, analysis of the litigated cases, and conclusion. Each case is listed in Appendix III, where the cases are categorized by type of taxpayer (*i.e.*, individual or business).<sup>6</sup> Appendix III also provides the citation for each case, indicates whether the taxpayer was represented at trial or argued the case *pro se* (*i.e.*, without representation), and lists the court's decision.<sup>7</sup>

Following this introduction is 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. We do not include settled cases in the count of cases for the Most Litigated Issues; however, this research study is relevant because its findings may shed light on how IRS practices affect the timing of when a case is resolved. We have also included a "Significant Cases" section that summarizes important decisions that are relevant to tax administration but were not included in the above-listed top ten issues.<sup>8</sup>

## AN OVERVIEW OF HOW TAX ISSUES ARE LITIGATED

Initially, taxpayers can generally litigate a tax matter in four different courts: the United States Tax Court, United States District Courts, the United States Court of Federal Claims, and United States Bankruptcy Courts. With limited exceptions, taxpayers have an automatic right of appeal from decisions of any of these courts.<sup>9</sup>

The Tax Court is generally a "prepayment" forum. In other words, taxpayers can access the Tax Court without having to pay the disputed tax in advance. The Tax Court has jurisdiction over a variety of issues, including deficiencies, certain declaratory judgment actions, appeals from collection due process hearings, relief from joint and several liability, and determination of employment status.<sup>10</sup>

The United States District Courts and the United States Court of Federal Claims have concurrent jurisdiction over tax matters in which (1) the tax has been assessed and paid in

<sup>6</sup> Individuals filing Schedules C, E, or F are deemed business taxpayers for purposes of this discussion even if items reported on such schedules were not the subject of litigation.

<sup>7</sup> "Pro se" means "for oneself; on one's own behalf; without a lawyer." *Black's Law Dictionary* (9th ed. 2009). For purposes of this analysis, we considered the court's decision with respect to the issue analyzed only. A "split" decision is defined as a partial allowance on the specific issue analyzed. The citations also indicate whether decisions were on appeal at the time this report went to print.

<sup>8</sup> One of the cases discussed in the "Significant Cases" section of this report was decided outside the June 1, 2010, through May 31, 2011 period used to identify the ten most litigated issues, but we nonetheless have included it because of its impact on tax administration.

<sup>9</sup> See IRC § 7482, which provides that the United States Courts of Appeals (other than the United States Court of Appeals for the Federal Circuit) have jurisdiction to review the decisions of the Tax Court. There are exceptions to this general rule. For example, IRC § 7463 provides special procedures for small Tax Court cases (where the amount of deficiency or claimed overpayment totals \$50,000 or less) for which appellate review is not available. See also 28 U.S.C. § 1294 (appeals from a United States District Court are to the appropriate United States Court of Appeals); 28 U.S.C. § 1295 (appeals from the United States Court of Federal Claims are heard in the United States Court of Appeals for the Federal Circuit); 28 U.S.C. § 1254 (appeals from the United States Courts of Appeals may be reviewed by the United States Supreme Court).

<sup>10</sup> IRC §§ 6214; 7476-7479; 6330(d); 6015(e); 7436.

full,<sup>11</sup> and (2) the taxpayer has filed an administrative claim for refund.<sup>12</sup> The United States District Courts, along with the bankruptcy courts in very limited circumstances, provide the only forums in which a taxpayer can receive a jury trial.<sup>13</sup> Bankruptcy courts can adjudicate tax matters that were not adjudicated prior to the initiation of a bankruptcy case.<sup>14</sup>

### ANALYSIS OF PRO SE LITIGATION

As in previous years, many taxpayers appeared before the courts *pro se*. Table 3.0.1 lists the Most Litigated Issues for the period of June 1, 2010, through May 31, 2011, and identifies the number of cases, broken down by issue, in which taxpayers appeared without representation. As illustrated in the table below, the issues with the highest rates of *pro se* taxpayers are the frivolous issues penalty and the failure to file penalty. The high percentages of *pro se* taxpayers litigating these issues suggest that representatives may be unwilling to take these kinds of cases, or that these issues affect many low and middle income taxpayers who cannot afford representation. The data may suggest a need for more low income taxpayer clinics (LITCs) and volunteers to provide free or low-cost representation.

**TABLE 3.0.1, Pro Se Cases by Issue**

| Most Litigated Issue  | Total Number of Litigated Cases Reviewed | Pro Se Litigation | Percentage of Pro Se Cases |
|---|--|-------------------|----------------------------|
| Summons Enforcement   | 132                                      | 98                | 74%                        |
| Trade or Business Expenses  | 107                                      | 31                | 29%                        |
| Collection Due Process  | 89                                       | 56                | 63%                        |
| Failure to File and Estimated Tax Penalties   | 74                                       | 65                | 88%                        |
| Gross Income  | 62                                       | 46                | 74%                        |
| Accuracy-Related Penalty  | 55                                       | 24                | 44%                        |
| Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax | 48                                       | 25                | 52%                        |
| Joint and Several Liability   | 44                                       | 23                | 52%                        |
| Frivolous Issues Penalty (and analogous appellate-level sanctions)                  | 44                                       | 42                | 95%                        |
| Charitable Deduction  | 27                                       | 13                | 14%                        |
| <b>Total</b>  | <b>682</b>                               | <b>423</b>        | <b>62%</b>                 |

Table 3.0.2 demonstrates our belief that overall, taxpayers are more likely to prevail if they are represented. However, *pro se* taxpayers actually experienced a substantially higher rate of success than represented taxpayers in litigation over trade or business expenses. The higher success rate for *pro se* taxpayers litigating this issue is noteworthy and indicates

<sup>11</sup> 28 U.S.C. § 1346(a)(1). See *Flora v. United States*, 362 U.S. 145 (1960), *reh'g denied*, 362 U.S. 972 (1960).

<sup>12</sup> IRC § 7422(a).

<sup>13</sup> The bankruptcy court may only conduct a jury trial if the right to a trial by jury applies, all parties expressly consent, and the district court specifically designates the bankruptcy judge to exercise such jurisdiction. 28 U.S.C. § 157(e).

<sup>14</sup> See 11 U.S.C. §§ 505(a)(1) and (a)(2)(A).

possible communication barriers between taxpayers and the IRS in the administrative process.

**TABLE 3.0.2, Outcomes for *Pro Se* and Represented Taxpayers**

| Most Litigated Issue  | <i>Pro Se</i> Taxpayers |  |            | Represented Taxpayers |  |            |
|---|-------------------------|--|------------|-----------------------|--|------------|
|   | Total Cases             | Taxpayer Prevailed in whole or in part | Percent    | Total Cases           | Taxpayer Prevailed in whole or in part | Percent    |
| Summons Enforcement   | 98                      | 3                                      | 3%         | 34                    | 8                                      | 24%        |
| Trade or Business Expenses  | 31                      | 18                                     | 58%        | 76                    | 30                                     | 39%        |
| Collection Due Process  | 56                      | 3                                      | 5%         | 33                    | 3                                      | 9%         |
| Failure to File and Estimated Tax Penalties   | 65                      | 4                                      | 6%         | 9                     | 2                                      | 22%        |
| Gross Income  | 46                      | 6                                      | 13%        | 16                    | 3                                      | 19%        |
| Accuracy-Related Penalty  | 24                      | 6                                      | 25%        | 31                    | 13                                     | 42%        |
| Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax | 25                      | 2                                      | 8%         | 23                    | 4                                      | 17%        |
| Joint and Several Liability   | 23                      | 10                                     | 43%        | 21                    | 10                                     | 48%        |
| Frivolous Issues Penalty (and analogous appellate-level sanctions)                  | 42                      | 18                                     | 43%        | 2                     | 0                                      | 0%         |
| Charitable Deduction  | 13                      | 1                                      | 8%         | 14                    | 4                                      | 29%        |
| <b>Total</b>  | <b>423</b>              | <b>71</b>                              | <b>17%</b> | <b>259</b>            | <b>77</b>                              | <b>30%</b> |

## Characteristics of Earned Income Tax Credit Cases that the IRS Fully Concedes in Tax Court

This discussion of the ten Most Litigated Issues 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.<sup>1</sup> 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. Some cases are closed because the taxpayer defaults or the case is dismissed, but the largest category of closed cases, more than 75 percent 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*, that 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. If these cases present common elements, the IRS may be able to adjust its procedures so that concessions, where appropriate, can be made earlier (perhaps during the Examination phase, or in any event before a Tax Court petition is filed). The IRS has an interest in the answer to this question because earlier resolution of cases conserves resources by reducing or eliminating Appeals or Chief Counsel involvement.

TAS conducted a focus group with three Chief Counsel paralegals who work with and routinely settle docketed cases involving EITC. We then developed a data collection instrument that explores the characteristics of a fully-conceded EITC case, such as:

- Whether the return at issue was prepared by a paid preparer;
- How long the case was in IRS Examination;
- Whether the taxpayer responded or instead “dropped out” of the original exam;
- Whether the taxpayer submitted information to the IRS during the exam that the IRS did not process or consider before the taxpayer filed the Tax Court petition;
- How long it took to settle the case once the Tax Court petition was filed;
- Whether the taxpayer was represented;
- Whether and when the taxpayer or representative spoke to the IRS by telephone or in person;
- Whether Counsel or Appeals accepted testimony as a substitute for documents;

<sup>1</sup> The data in this paragraph are from the IRS Office of Chief Counsel report prepared for American Bar Association, Tax Section, Court Procedure Committee (2011) 6, 19.

## Characteristics of Earned Income Tax Credit Cases that the IRS Fully Concedes in Tax Court

- Whether another taxpayer claimed the same person as a qualifying child; and
- Whether Counsel or Appeals found the examiner misapplied the law.

We will use the data collection instrument to evaluate cases in our sample, which is likely to consist of approximately 300 cases, depending on the size of the population.

Once we obtain a sample that when analyzed will allow us to describe the relevant population with a 95 percent confidence level and a precision margin of +/- five percent, we will proceed to retrieve and analyze those case files. We expect preliminary results within three months after identifying the sample cases, and we plan to publish our findings in the National Taxpayer Advocate's 2012 Annual Report to Congress.

## 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.<sup>1</sup> These decisions are summarized below.

**In *Arizona Christian School Tuition Organization v. Winn*, the Supreme Court held that a taxpayer lacked standing to challenge a state tuition tax credit (i.e., a so-called “tax expenditure”) as violating the Establishment Clause, even though taxpayers generally have standing to challenge the use of more direct government expenditures.**<sup>2</sup>

Arizona law provided dollar-for-dollar tax credits of up to \$500 per person and \$1,000 per married couple for contributions to “student tuition organizations” (STO). STOs used the contributions to provide scholarships to students attending private schools, including religious schools. The Arizona Christian School Tuition Organization, a group of Arizona taxpayers, challenged the STO tax credit as a violation of Establishment Clause principles under the First and Fourteenth Amendments to the U.S. Constitution. The group alleged the statute allowed STOs to use Arizona income tax revenues to pay tuition for students at religious schools, some of which discriminated on the basis of religion in selecting students.

In a majority opinion by Justice Kennedy, joined by Chief Justice Roberts and Justices Scalia, Thomas, and Alito, the Court held that the Arizona taxpayers lacked standing under Article III of the Constitution to obtain a determination on the merits in federal court. The Court distinguished its decision from *Flast v. Cohen*,<sup>3</sup> where it determined that taxpayers had standing to challenge the direct expenditure of federal funds to purchase textbooks and other instructional materials for use in religious schools. In the case of direct expenditures, taxpayers may suffer sufficient injury to have standing because “their property is transferred through the Government’s Treasury to a sectarian entity.”<sup>4</sup> In the case of tax expenditures, by contrast, the Court reasoned that taxpayers sustain no such injury because the government does not “extract and spend,” but rather, allows taxpayers to retain their own funds. The Court deemed the need to raise other taxes to fund operations as too speculative to trigger standing. It observed that funding STOs could reduce the need for expenditures on public schools, potentially offsetting any financial loss to the state. Even if the tax credit did result in a financial loss, there was no way to know if the legislature would react to an invalidation of the tax credit and reversal of any such loss by reducing taxes.

<sup>1</sup> When identifying the ten most litigated issues, TAS analyzed federal decisions issued during the period beginning on June 1, 2010, and ending on May 31, 2011. For purposes of this section of the report, we generally use the same period.

<sup>2</sup> 131 S.Ct. 1436 (2011), *rev’g* 562 F.3d 1002 (9th Cir. 2009).

<sup>3</sup> 392 U.S. 83 (1968).

<sup>4</sup> *Arizona Christian School Tuition Org.*, 131 S.Ct. at 1446 (citing *Flast*, 392 U.S. at 105-106).

## Significant Cases

This decision is significant because it provides an incentive for legislators to use nonrefundable tax expenditures in lieu of direct expenditures because they may be less susceptible to constitutional challenge.<sup>5</sup> It is unclear if refundable tax expenditures (*e.g.*, refundable education tax credits), which are more akin to direct expenditures, would receive the same protection as nonrefundable tax expenditures. It appears that a majority of the Court, however, would not have drawn a distinction between direct spending and tax expenditures.<sup>6</sup>

***In Mayo Foundation for Medical Education and Research v. United States, the Supreme Court held that “interpretive” Treasury regulations were entitled to Chevron deference, and accordingly, a hospital’s medical residents who regularly worked 40 hours or more per week were not eligible for the student exemption from Federal Insurance Contributions Act (FICA) taxes.<sup>7</sup>***

Wages are generally subject to FICA taxes.<sup>8</sup> However, wages paid by a school to its “students” may be eligible for an exception if the work is “incident to and for the purpose of pursuing a course of study.”<sup>9</sup> Whether a person qualifies for the student exception has historically been determined based on an analysis of various facts and circumstances, including the number of hours worked.<sup>10</sup> In 2004, the IRS amended the FICA regulations, establishing a bright-line rule that a person whose normal work schedule is 40 hours or more per week is a full-time employee and therefore ineligible for the student exception.<sup>11</sup>

The Mayo Foundation paid FICA taxes for its medical residents who regularly work 40 hours or more per week, and then filed a refund suit in district court, challenging the validity of the 2004 regulations. The district court held that the regulations were invalid.<sup>12</sup> First, it noted that the validity of “interpretive” regulations—regulations issued pursuant to general authority under IRC § 7805(a) rather than a specific legislative directive—should be analyzed using the heightened standard identified by the Supreme Court in *National Muffler* rather than the more deferential standard set forth in *Chevron*.<sup>13</sup> Then it concluded that the regulations were invalid under either test.<sup>14</sup>

<sup>5</sup> For a detailed discussion of tax expenditures, see National Taxpayer Advocate 2010 Annual Report to Congress, vol. 2, 101-119 (*Evaluate the Administration of Tax Expenditures*).

<sup>6</sup> In a concurring opinion, Justice Scalia, joined by Justice Thomas, argued that taxpayers should not have standing to challenge either direct expenditures or tax expenditures. In a dissenting opinion, Justice Kagan, joined by Justices Ginsburg, Breyer, and Sotomayor, argued that taxpayers should have standing to challenge both direct expenditures and tax expenditures.

<sup>7</sup> 131 S.Ct. 704 (2011), *aff’g* 568 F.3d 675 (8th Cir. 2009), *rev’g* 503 F. Supp. 2d 1164 (D. Minn. 2007) (hereinafter *Mayo*). For prior coverage, see National Taxpayer Advocate 2009 Annual Report to Congress, 407, 412-413; National Taxpayer Advocate 2008 Annual Report to Congress 459, 462-463.

<sup>8</sup> See IRC § 3101 *et seq.*

<sup>9</sup> IRC § 3121(b)(10); Treas. Reg. § 31.3121(b)(10)-2(d)(3)(iii). The Social Security Act, which governs workers’ eligibility for benefits, contains a similar student exception. 42 U.S.C. § 410(a)(10).

<sup>10</sup> See Rev. Rul. 78-17, 1978-1 C.B. 306.

<sup>11</sup> T.D. 9167, 69 Fed. Reg. 76,404, 76,405 (Dec. 21, 2004) (effective for services performed on or after April 1, 2005).

<sup>12</sup> *Mayo*, 503 F. Supp. 2d at 1164.

<sup>13</sup> *Id.* at 1171.

<sup>14</sup> *Id.* at 1174.

## Significant Cases

Under *Chevron*, agency regulations are entitled to deference (sometimes called “*Chevron* deference”) unless they contradict an unambiguous statute or set forth an unreasonable construction of it.<sup>15</sup> Under the heightened *National Muffler* standard, a court considers whether a regulation is a substantially contemporaneous construction of the statute, the length of time the regulation has been in effect, the manner in which it evolved, the reliance placed on it, the consistency of the IRS’s interpretation, and whether Congress has scrutinized the regulation in subsequent amendments or reenactments of the statute.<sup>16</sup> The district court in *Mayo* explained that the regulations were invalid under *Chevron* because the plain language of the statute was not ambiguous. Moreover, pursuant to *National Muffler*, the fact that the regulations were issued long after the statute was enacted and in the wake of an adverse court decision weighed against the government.<sup>17</sup>

The Court of Appeals for the Eighth Circuit reversed, holding that the 2004 regulations were valid.<sup>18</sup> Applying *Chevron*, it reasoned that the statute was ambiguous and that the regulations were a reasonable construction of it.<sup>19</sup> However, it also applied the factors set forth in *National Muffler*.<sup>20</sup> Like the district court, the Eighth Circuit’s analysis assumed an interpretive regulation that upsets settled expectations years after a statute is enacted is more likely to be invalid, as suggested by *National Muffler*.<sup>21</sup>

The Supreme Court affirmed the Eighth Circuit’s holding, declaring that *Chevron* deference applies to all regulations, even if those regulations are promulgated long after a statute is enacted, reverse longstanding agency positions, or are prompted by litigation.<sup>22</sup> The Court rejected the notion that the analysis is any different for “interpretive” regulations than for “legislative” regulations. Applying *Chevron*, it found the term “student” was ambiguous. Next, it concluded that the regulation’s definition was reasonable, particularly in light of the fact that the agency used the notice-and-comment procedure to issue the regulation. It noted that the preamble to the regulations explained that the bright-line 40-hour-a-week rule was adopted to improve the administrability of the provision and to address concerns raised by the Social Security Administration.

<sup>15</sup> *Chevron U.S.A., Inc. v. Natural Res. Defense Council, Inc.*, 467 U.S. 837, 842-43 (1984).

<sup>16</sup> *Nat’l Muffler Dealers Ass’n, Inc. v. United States*, 440 U.S. 472, 477 (1979) (citations omitted).

<sup>17</sup> *Mayo*, 503 F.Supp.2d at 1176.

<sup>18</sup> *Mayo*, 568 F.3d at 684.

<sup>19</sup> *Id.* at 682.

<sup>20</sup> *Id.* at 682-83.

<sup>21</sup> *Id.* at 682.

<sup>22</sup> *Mayo*, 131 S.Ct. at 713-714.

## Significant Cases

This case is significant because it may assist the government in defending interpretive Treasury regulations, particularly regulations issued to address losses in court.<sup>23</sup> Given the Supreme Court’s emphasis on the importance of the notice-and-comment process and the strength of the government’s justification for the rule, however, the decision may be less helpful in defending regulations that sidestep the notice-and-comment process, such as those that are effective before the public has had an opportunity to offer comments or those that do not provide any justification for adopting a rule.<sup>24</sup>

**In *Grapevine Imports, Ltd. v. United States*, the Court of Appeals for the Federal Circuit held that Treasury regulations were entitled to *Chevron* deference, and accordingly an overstatement of basis triggered the extended six-year statute of limitations on assessment in IRC § 6501(e).<sup>25</sup>**

Mr. and Mrs. Tigue owned Grapevine Imports, Ltd. (Grapevine), a limited liability partnership. In 1999, they caused Grapevine to enter into a so-called Son-of-BOSS (Bond and Option Sales Strategy) tax shelter and then sold it. They took the position that the tax shelter increased their basis in Grapevine, thereby reducing taxable gain on the sale. In 2004, more than three but less than six years after Grapevine filed returns for 1999, the IRS issued a Final Partnership Administrative Adjustment (FPAA), increasing the gain on the sale.

Grapevine challenged the FPAA in the Court of Federal Claims, arguing the FPAA was time-barred because the IRS issued it after the expiration of the three-year statute of limitations under IRC §§ 6501(a) and 6229(a).<sup>26</sup> The government disagreed, contending that Grapevine’s overstatement of basis was a substantial omission from “gross income” that triggered the extended six-year statute of limitations under IRC §§ 6501(e)(1)(A) and 6229(c)(2). The Court of Federal Claims sided with Grapevine, holding that an overstatement of basis is not an omission from gross income for purposes of IRC § 6501(e)(1)(A).<sup>27</sup>

By way of background, the Courts of Appeals for the Fifth, Ninth, and Federal Circuits had previously held that an overstatement of basis is not an omission from gross income for

<sup>23</sup> See, e.g., Amy S. Elliott, *Mayo Decision ‘Means More Guidance Faster’ From IRS, Official Says*, 2011 TNT 15-7 (Jan. 24, 2011) (quoting the IRS Deputy Associate Chief Counsel (Technical) as saying, “the less-deferential multifactor test in *National Muffler Dealers Association Inc. v. United States*, 440 U.S. 472 (1979) is dead.”); Jeremiah Coder, *Federal Circuit Grapples with Aftermath of Mayo*, 2011 TNT 9-2 (Jan. 13, 2011) (reporting the government cited the Mayo decision in its oral argument before a panel of judges on the U.S. Court of Appeals for the Federal Circuit where it was defending the validity of section 6501 regulations); Jeremiah Coder, *Officials Comment On Interpreting Mayo*, 2011 TNT 16-4 (Jan. 25, 2011) (reporting the Acting Deputy Assistant Attorney General indicated that “when Congress passes an ambiguous statute, any Treasury regulation is probably valid under Mayo. . . [and] even revenue rulings should be subject to *Chevron* deference”). But see, *Home Concrete & Supply, LLC v. United States*, 634 F.3d 249 (4th Cir. 2011) (holding that Treasury regulations were not entitled to *Chevron* deference because, according to a pre-*Chevron* Supreme Court opinion that analyzed legislative history, the statute was not ambiguous).

<sup>24</sup> See, e.g., Amy S. Elliott, *Mayo Decision ‘Means More Guidance Faster’ From IRS, Official Says*, 2011 TNT 15-7 (Jan. 24, 2011) (quoting the IRS Deputy Associate Chief Counsel (Technical) as saying “the IRS will take to heart the Court’s emphasis on the importance of notice and comment in its regulatory process.”).

<sup>25</sup> 636 F.3d 1368 (Fed. Cir. 2011), *reh’g en banc denied*, 2011 U.S. App. LEXIS 14144 (June 6, 2011), *rev’g* 77 Fed. Cl. 505 (2007).

<sup>26</sup> *Grapevine Imports Ltd. v. United States*, 77 Fed. Cl. 505 (2007).

<sup>27</sup> *Id.* at 512.

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purposes of IRC § 6501(e)(1)(A).<sup>28</sup> These decisions cite the Supreme Court's 1958 decision in *Colony*, which held that an overstatement of basis is not an omission from gross income (under a predecessor of IRC § 6501(e)) because no income is "left out" of the return.<sup>29</sup> By contrast, the Court of Appeals for the Seventh Circuit recently agreed with the government's view that *Colony's* holding is limited to overstatements of basis on the sale of goods and services by a trade or business, rather than the sale of capital assets.<sup>30</sup> Therefore, the court applied the general definition of gross income in IRC § 61 and concluded that the taxpayers' overstatement of basis resulted in an understatement of gross income sufficient to trigger the six-year limitations period.<sup>31</sup>

While numerous cases were pending in the courts, the IRS issued temporary and final regulations in 2009 and 2010, respectively, which mirror its litigating position that outside of a trade or business context, an overstatement of basis is an omission from gross income for purposes of IRC § 6501(e).<sup>32</sup>

In this case, the Court of Appeals for the Federal Circuit sided with the government. It distinguished its own prior decision in *Salman Ranch*, which was decided before the government issued the temporary regulations. Citing the recent Supreme Court decision in *Mayo* (discussed above), it applied the two-step test set forth in *Chevron* (discussed above), and concluded the final regulations were entitled to deference because (1) the statute was ambiguous and (2) the regulations were not unreasonable.<sup>33</sup> The court also discounted Grapevine's argument that the regulations did not or should not apply retroactively.<sup>34</sup> The resulting split among the circuits makes it more likely that the Supreme Court will decide to review this issue.

<sup>28</sup> See, e.g., *Salman Ranch Ltd. v. United States*, 573 F.3d 1362 (Fed. Cir. 2009); *Bakersfield Energy Partners, LP v. Comm'r*, 568 F.3d 767 (9th Cir. 2009); *Burks v. United States*, 633 F.3d 347 (5th Cir. 2011); *Home Concrete & Supply, LLC v. United States*, 634 F.3d 249 (4th Cir. 2011), cert. granted, 2011 U.S. LEXIS 5196 (Sept. 27, 2011). For prior coverage of this issue, see National Taxpayer Advocate 2010 Annual Report to Congress 418, 423 (discussing *Intermountain Ins. Serv. of Vail, LLC v. Comm'r*, 134 T.C. 211 (2010), rev'd, 650 F.3d 691 (D.C. Cir. 2011)) and National Taxpayer Advocate 2009 Annual Report to Congress 407, 416 (discussing *Bakersfield Energy Partners, LP v. Comm'r*, 568 F.3d 767 (9th Cir. 2009)).

<sup>29</sup> *The Colony, Inc. v. Comm'r*, 357 U.S. 28 (1958) (hereinafter *Colony*).

<sup>30</sup> *Beard v. Comm'r*, 633 F.3d 616 (7th Cir. 2011), reh'g en banc denied, 107 A.F.T.R.2d (RIA) 1771 (7th Cir. 2011) (reasoning that because the taxpayers were not engaged in a trade or business, *Colony* was not controlling).

<sup>31</sup> *Beard*, 633 F.3d at 621, 622.

<sup>32</sup> T.D. 9466, 74 Fed. Reg. 49,321 (Sept. 28, 2009) (temporary regulations); T.D. 9511, 75 Fed. Reg. 78,897 (Dec. 17, 2010) (final regulations).

<sup>33</sup> *Accord Beard*, 633 F.3d at 623 (citations omitted) (noting that even if it had determined that *Colony* was controlling, the court would have applied *Chevron* deference to both the temporary and final regulations, regardless of the fact that the temporary regulations had not been subject to notice and comment). In contrast, the Court of Appeals for the Fifth Circuit more recently characterized these regulations, which it deemed inapplicable, as "an unreasonable interpretation of settled law," and suggested it would not have given them deference. *Burks v. United States*, 633 F.3d 347, n.9 (5th Cir. 2011) (speculating that the lack of notice and comment may have been fatal and quoting Supreme court precedent stating that "[D]eference to what appears to be nothing more than an agency's convenient litigating position" is "entirely inappropriate." (internal citations omitted)).

<sup>34</sup> In contrast, the Tax Court concluded that the regulations were invalid and criticized the effective date of those regulations as being circular. See *Intermountain Ins. Serv. of Vail, LLC v. Comm'r*, 134 T.C. 211 (2010), rev'd, 650 F.3d 691 (D.C. Cir. 2011). For a discussion of *Intermountain*, see National Taxpayer Advocate 2010 Annual Report to Congress 418, 423.

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**In *Perry v. Commissioner*, the Tax Court declined to enjoin the IRS from offsetting a refund to collect an unassessed liability that the taxpayer was disputing.<sup>35</sup>**

In August of 2008, the IRS sent Mr. Perry a notice of deficiency with respect to his 2002 return. In October 2008, it applied his 2007 overpayment to offset part of the deficiency. In November 2008, Mr. Perry filed a timely petition in the Tax Court to contest the deficiency. He subsequently filed a motion seeking an order to: (1) enjoin the IRS from offsetting his 2007 refund against the 2002 deficiency, and (2) have the IRS refund his 2007 overpayment.

Mr. Perry argued that IRC § 6213(a) prohibits the IRS from engaging in all collection activities, including offsets, during the period in which the taxpayer may petition the Tax Court (*i.e.*, 90 or 150 days after the notice of deficiency is mailed), or if the taxpayer files a petition, until the court's decision becomes final. Mr. Perry argued that the “underlying fundamental principle” of the statute is that during the period in which the statute's restriction is in effect, the IRS is prohibited from collecting by any means, including an offset, a deficiency that a taxpayer may dispute in the Tax Court.

The IRS argued that the plain language of IRC § 6213(a) only prohibits certain assessments, levies, and in-court collection proceedings—not offsets. The court agreed with the IRS and dismissed Mr. Perry's motion.

This case may be significant because, in response to calls for legislation to prevent the IRS from collecting unassessed and disputed liabilities using its offset authority, the IRS stated that its procedures generally prevent it from using offsets to collect an individual's disputed liabilities before they are assessed.<sup>36</sup> The case shows that IRS procedures do not always prevent it from collecting disputed liabilities from taxpayers, using its offset authority.<sup>37</sup> IRS procedures failed to preserve the taxpayer's ability to dispute the IRS-asserted liability in the Tax Court before paying it. Accordingly, it represents an example of a case in which legislation could be helpful, particularly since the IRS's assurance was inaccurate.<sup>38</sup>

<sup>35</sup> T.C. Memo. 2010-219.

<sup>36</sup> When the IRS published Rev. Rul. 2007-51, 2007-2 C.B. 573, which concluded that the IRS may offset overpayments against IRS-asserted, but unassessed and disputed liabilities, it provoked criticism that low-income taxpayers would be deprived of an opportunity to seek judicial review of the matter in the Tax Court before paying the tax. Letter from Carlton M. Smith, Director of the Cardozo Tax Clinic, Benjamin N. Cardozo School of Law, to Hon. Charles B. Rangel, Chairman, House Ways and Means Committee and Hon. Max Baucus, Chairman, Senate Finance Comm., *reprinted as, Associate Professor Calls IRS Ruling 'Harmful To Low-Income Taxpayers'*, 2007 TNT 185-70 (Sept. 24, 2007). The IRS responded, in part, by explaining that its procedures “are not designed to setoff an overpayment against a liability prior to the time the liability is assessed” and describing how IRS procedures prevent such offsets. Letter from Deborah A. Butler, Associate Chief Counsel (Procedure and Administration), IRS Office of Chief Counsel, to Carlton M. Smith, Director of the Cardozo Tax Clinic, Benjamin N. Cardozo School of Law, *reprinted as, IRS Maintains Legality of Revenue Ruling on Refund Offsets in Letter to Law Professor*, 2008 TNT 5-9 (Jan. 8, 2008).

<sup>37</sup> One recent article cites speculation that this case may indicate that the IRS has changed its procedures and that the existing statutory scheme that permits such offsets should be revisited. Sam Young, *Tax Court Opinion on Individual Overpayments Brings Practitioner Fears to Life*, 2010 TNT 201-3 (Oct. 19, 2010).

<sup>38</sup> The National Taxpayer Advocate has recommended legislation to help address this problem. National Taxpayer Advocate 2008 Annual Report to Congress 442 (Legislative Recommendation: *Crediting an Overpayment Against an Unassessed, Outstanding Tax Liability*); Legislative Recommendation: *Taxpayer Bill of Rights*, *supra*.

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**In *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, the Tax Court held that the distributive share of the income allocable to limited partners who are active in the partnership's business is subject to self-employment tax.<sup>39</sup>**

Renkemeyer, Campbell & Weaver, LLP was a three-person law firm organized as a limited liability partnership (LLP) under Kansas law. The firm made a special allocation of income to a fourth partner, which was an S corporation owned by a tax-exempt employee stock ownership plan (ESOP). After disregarding this special allocation and reallocating the income among the individual partners, the IRS determined that each individual partner's distributive share of the income was subject to self-employment tax.

In general, an individual general partner's distributive share of income or loss from any trade or business carried on by the partnership is subject to self-employment tax.<sup>40</sup> A limited partner's distributive share of a partnership's income (other than "guaranteed payments," such as the partner's salary), however, is generally not subject to self-employment tax because it is excluded under IRC § 1402(a)(13).<sup>41</sup>

The exclusion under IRC § 1402(a)(13) does not define the term "limited partner" with respect to entities not organized as limited partnerships (LPs). It was enacted in 1977, before limited liability partnerships (LLPs) and limited liability companies (LLCs) were contemplated. As LLPs and LLCs became more common, the Secretary issued proposed regulations, which would have defined "limited partner" for purpose of this exclusion.<sup>42</sup> These regulations caused such controversy that Congress prohibited the IRS from issuing regulations in this area before July 1, 1998, and the Senate passed a resolution calling for the withdrawal of the proposed regulation.<sup>43</sup>

In the absence of guidance from Congress, the Tax Court agreed with the IRS that the partners in the LLP were not "limited partners" for purposes of the exclusion from self-employment tax under IRC § 1402(a)(13). The Tax Court reasoned that one key difference between LPs and LLPs (and LLCs) is that a limited partner in an LP could lose his or her limited liability protection by engaging in the business operations of the partnership. Consequently, a limited partner in an LP is generally akin to a passive investor, whereas a limited partner in an LLP may enjoy limited liability protection even if actively managing the business. According to legislative history, Congress intended to exclude "earnings which are basically of an investment nature."<sup>44</sup> Because each partner had contributed a nominal amount (\$110) for a partnership unit, it was clear that the partners' distributive shares were not earnings

<sup>39</sup> 136 T.C. 137 (2011).

<sup>40</sup> IRC §§ 1401(a) and 1402(a).

<sup>41</sup> IRC § 1402(a)(3) provides in relevant part that "there shall be excluded [from net earnings subject to self-employment tax] the distributive share of any item of income or loss of a *limited partner*." (Emphasis added).

<sup>42</sup> 62 Fed. Reg. 1702 (Jan. 13, 1997); Prop. Treas. Reg. § 1.1402(a)-2.

<sup>43</sup> See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 935, 111 Stat. 788, 882 (1997). See also 143 Cong. Rec. 13297 (June 27, 1997).

<sup>44</sup> H.R. Rept. No. 95-702 (Part 1), at 9 (1977).

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of an investment nature, but rather arose from legal services they performed. Thus, the court held the distributive shares were subject to self-employment tax.

This decision is significant because it clarifies that the distributive shares of partners and members of LLPs and LLCs may be subject to self-employment taxes. It has reportedly sent “shock waves through the legal and accounting communities” because many law and accounting firms are organized as LLPs or LLCs.<sup>45</sup> By one estimate based on 2008 data, the decision could raise \$1.22 billion per year.<sup>46</sup>

**In *Cohen v. United States*, the Court of Appeals for the District of Columbia held that it had jurisdiction to review the IRS’s procedure for refunding telephone excise tax amounts that it had collected improperly.<sup>47</sup>**

In May 2006, after losing several court challenges regarding the application of telephone excise taxes, the IRS issued Notice 2006-50, which announced it would no longer collect the tax on telephone charges based solely on transmission time.<sup>48</sup> Notice 2006-50 also outlined a procedure for claiming refunds (usually about \$30-\$60 for individuals) of excise taxes that the IRS improperly collected after February 28, 2003, and before August 1, 2006.<sup>49</sup>

The class action appellants in this case challenged the lawfulness and adequacy of the IRS telephone excise refund process. They argued that Notice 2006-50 was substantively flawed because it under-compensated many taxpayers for the excise taxes actually paid, and procedurally flawed because it was not subject to notice and comment, as required by the Administrative Procedure Act (APA).<sup>50</sup> The district court dismissed the case, concluding that the appellants did not exhaust the administrative remedies and failed to state a valid claim under the APA or any other federal law.<sup>51</sup>

On appeal, the D.C. Circuit reversed and remanded the case to the district court for a decision on the merits of the APA claim.<sup>52</sup> Rehearing the case *en banc*, the Court of Appeals

<sup>45</sup> Martin A. Sullivan, *Economic Analysis: Renkemeyer Annual Cost to Partners Could Exceed \$1 Billion*, 2011 TNT 55-2 (Mar. 22, 2011).

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

<sup>47</sup> 108 A.F.T.R.2d (RIA) 5046 (D.C. Cir. 2011), *en banc rehearing of* 578 F.3d 1 (D.C. Cir. 2009), *rev’g sub nom. In re Long-Distance Tel. Service Fed. Excise Tax Refund Litig.*, 539 F. Supp. 2d 281 (D.C. 2008).

<sup>48</sup> Telephone service providers are required to collect from customers and pay directly to the IRS a three percent excise tax on certain phone calls. See IRC §§ 4251 and 4291. The tax applies to communications charges that are based upon distance and transmission time. IRC § 4252(b). With the rise of cellular phones, telephone service providers increasingly based fees solely on time without regard to distance. Various courts have held that such charges are not to be subject to the excise tax. See Notice 2006-50, 2006-1 C.B. 1141, *amplified and modified by* Notice 2007-11, 2007-1 C.B. 405.

<sup>49</sup> See Notice 2006-50, 2006-1 C.B. 1141.

<sup>50</sup> 5 U.S.C. § 551, *et seq.*

<sup>51</sup> *In re Long-Distance Tel. Service Fed. Excise Tax Refund Litig.*, 539 F. Supp. 2d 281 (D.C. 2008).

<sup>52</sup> The opinion states:

In sum, the IRS unlawfully expropriated billions of dollars from taxpayers, conceded the illegitimacy of its actions, and developed a mandatory process as the sole avenue by which the agency would consider refunding its ill-gotten gains. It cannot avoid judicial review of that process by simply designating it a policy statement. Notice 2006-50 constituted a final agency action that aggrieved taxpayers by hindering their access to court. Accordingly, we reverse the district court and remand Appellants’ APA claims for further consideration. *Cohen v. U.S.*, 578 F.3d 1, 12 (D.C. Cir. 2009).

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for the D.C. Circuit held that it had jurisdiction and the appellants stated a valid claim.<sup>53</sup> It reasoned that the district court had general jurisdiction to review cases and controversies involving federal law, such as the APA;<sup>54</sup> the APA provided a waiver of sovereign immunity for those seeking relief other than monetary damages;<sup>55</sup> and neither the Anti-Injunction Act (AIA) nor the Declaratory Judgment Act (DJA) barred the appellants' challenge.<sup>56</sup> Moreover, in addressing the IRS's argument that the appellants failed to exhaust administrative remedies before seeking judicial review, it explained that exhaustion was not required in this case because the challenge was to the adequacy of the administrative remedy itself.

Similarly, the AIA, which prohibits suits to restrain the assessment or collection of taxes, did not prevent the suit because the appellants were not seeking to restrain the assessment or collection of taxes, but rather challenging procedures for refunding taxes already collected. According to the court, the DJA likewise only bars suits seeking to prevent the assessment and collection of taxes.

This case may be significant because it suggests that, like those of other federal agencies, IRS actions may be subject to judicial review, at least when the plaintiff does not seek a remedy that would restrain the assessment or collection of tax. It also lends support to the notion that the IRS should subject more of its procedures and guidance to the notice and comment process.<sup>57</sup>

**In *United States v. Williams*, the District Court for the Eastern District of Virginia held that the government did not prove that a taxpayer's failure to report his foreign accounts on a *Report of Foreign Bank and Financial Accounts* (FBAR) was willful, even though Schedule B of his income tax return indicated that he had no foreign accounts and he acknowledged willfully failing to report income from the accounts on his return.<sup>58</sup>**

Mr. Williams, a U.S. citizen and New York University-trained lawyer, pled guilty to tax evasion and criminal conspiracy to defraud the government with respect to more than \$7 million in unreported income that he deposited in foreign accounts and more than \$800,000 in earnings on those deposits. In connection with this plea, Mr. Williams admitted that he

<sup>53</sup> *Cohen*, 108 A.F.T.R.2d (RIA) at 5046.

<sup>54</sup> See 28 U.S.C. § 1331.

<sup>55</sup> See 5 U.S.C. § 702.

<sup>56</sup> IRC § 7421(a) (AIA) ("Except as provided in [specified sections]... no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person"); 28 U.S.C. § 2201(a) (DJA) ("In a case of actual controversy within its jurisdiction, except with respect to Federal taxes other than actions brought under section 7428 of the Internal Revenue Code of 1986 [other exceptions omitted]..., as determined by the administering authority, any court of the United States, upon the filing of an appropriate pleading, may declare the rights and other legal relations of any interested party seeking such declaration...").

<sup>57</sup> For a discussion of other problems with the IRS's use of unreviewed guidance such as "frequently asked questions," see Most Serious Problem, *The IRS's Failure to Consistently Disclose and Vet Its Procedures Harms Taxpayers, Deprives It of Valuable Comments, and Violates the Law*, *supra*.

<sup>58</sup> 2010-2 U.S.T.C. ¶ 50,623 (E.D. Va. 2010). In the related case of *Williams v. Comm'r*, 131 T.C. 54 (2008), the Tax Court held that it lacked jurisdiction to redetermine the taxpayer's liability for FBAR penalties. For a discussion of that case, see National Taxpayer Advocate 2009 Annual Report to Congress 413. For a helpful discussion of both cases, see Hale E. Sheppard, *District Court Rules that Where There's No Will, There's a Way to Avoid FBAR Penalties*, 113 J. Tax'n 293 (Nov. 2010).

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intentionally failed to report income in an effort to evade income taxes between 1993 and 2000. Acting on a request from the U.S., the Swiss government froze his accounts in 2000.

A U.S. person with a financial interest in, or signature authority over, one or more foreign financial accounts with an aggregate value greater than \$10,000 is required to file Form TD F 90–22.1, *Report of Foreign Bank and Financial Accounts (FBAR)*, by June 30 of each year.<sup>59</sup> In addition, *U.S. Individual Income Tax Return*, Form 1040, Schedule B asks:

At any time during 2010, did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account? [Yes/No.] See instructions on back for exceptions and filing requirements for Form TD F 90-22.1

Although Mr. Williams pled guilty in 2003, he did not file any FBARs for 1993 through 2000 until 2007, at which point the six-year period for imposing an FBAR penalty had expired for each year except 2000. He or his preparer checked “no” in the box on Schedule B of his 2000 return, indicating that he had no foreign accounts.

After sentencing, the IRS initiated a civil examination of Mr. Williams and sought to impose the maximum FBAR penalty for 2000.<sup>60</sup> To succeed, it had to meet its burden to prove that Mr. Williams “willfully” violated a known legal duty to file the FBAR (*i.e.*, that he knew he was required to file and intentionally failed to do so).<sup>61</sup> The IRS argued that his failure to file was willful because his signature on the tax return was *prima facie* evidence that he knew the contents of the return. In other words, the IRS sought to infer that the violation was willful from the fact that he signed a return that referenced the FBAR filing requirement next to a false statement indicating that he had no foreign accounts. The IRS also argued that Mr. Williams’ guilty plea should estop him from arguing that he did not willfully violate the FBAR reporting requirement.

The court held that the government failed to establish Mr. Williams willfully violated the FBAR reporting requirement. It concluded that Mr. Williams’ plea acknowledged he intentionally failed to report income on his return, but not that he willfully failed to file the FBAR. Mr. Williams testified that he relied on his accountants to fill out his Form 1040 and the court was not persuaded that he was lying about his ignorance as to its contents or the requirement to file the FBAR. The court noted that he failed to file the FBAR in June 2001, after he learned that U.S. and Swiss authorities knew about the accounts and had frozen them. Moreover, he disclosed the accounts during conversations with the IRS in January 2002, disclosures that would be consistent with his belief that the IRS already knew about

<sup>59</sup> See 31 U.S.C. § 5314; 31 C.F.R. § 1010.350(a).

<sup>60</sup> Prior to 2004, 31 U.S.C. § 5321(a)(5)(B) provided that a person who willfully violated the requirement to file an FBAR could be subject to a civil penalty of up to \$100,000 per account, per year. The American Jobs Creation Act of 2004, Pub. L. No. 108-357, Title VIII, § 821(a), 118 Stat. 1418, 1586 (2004) amended 31 U.S.C. § 5321(a)(5) to establish a penalty for non-willful violations and to increase the penalty for willful violations.

<sup>61</sup> See, e.g., *Ratzlaf v. United States*, 510 U.S. 135 (1994); IRM 4.26.16.4.5.3 (July 1, 2008).

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the accounts six months before in June 2001, when he was alleged to have willfully failed to disclose the accounts. This case is significant because it indicates that a taxpayer's response to the checkbox on Schedule B may be insufficient to establish that a taxpayer willfully violated the FBAR requirements, even if the taxpayer intentionally omitted income from the accounts on his or her return.<sup>62</sup>

**In *Cooper v. Commissioner*, the Tax Court held that it had jurisdiction to review the IRS's denial of a whistleblower claim.<sup>63</sup>**

Mr. Cooper submitted two whistleblower claims to the IRS in 2008 on Forms 211, *Application for Award for Original Information*.<sup>64</sup> Nine months after notifying Mr. Cooper that it had received his claims, the IRS Whistleblower Office notified him by letter that it could not make an award determination because he “did not identify federal tax issue[s] upon which the IRS will take action” and the information did not “result in the detection of the underpayment of taxes.”<sup>65</sup> Mr. Cooper timely petitioned the Tax Court to review the IRS's determination within 30 days of receiving the letter.

The IRS argued that the Whistleblower Office's letter did not constitute a “determination regarding an award” that would confer Tax Court jurisdiction under IRC § 7623(b)(4). It argued there can be such a determination only if the Whistleblower Office undertakes an administrative or judicial action and thereafter determines to make an award. The IRS also argued that its letter to Mr. Cooper was not a determination because it was not labeled as such. The court rejected both arguments. Citing legislative history, the court explained that the statute permits an individual to seek judicial review of either the amount or denial of an award.<sup>66</sup> The court also explained that the name or label of a document does not control whether it constitutes a determination conferring jurisdiction.<sup>67</sup> Accordingly, the Tax Court had jurisdiction to review the IRS's denial of the claims and denied the government's motion to dismiss.<sup>68</sup>

<sup>62</sup> Compare *U.S. v. Sturman*, 951 F.2d 1466 (6th Cir. 1991) (suggesting that the failure to answer the questions on Form 1040, Schedule B, regarding signature authority over foreign accounts can create an inference that the failure to file an FBAR was willful) and IRM 4.26.16.4.5.3(6) (July 1, 2008) (“[t]he mere fact that a person checked the wrong box, or no box, on a Schedule B is not sufficient, by itself, to establish that the FBAR violation was attributable to willful blindness.”). For a discussion of problems with the IRS's 2009 offshore voluntary compliance program, see Most Serious Problem, *The IRS's Offshore Voluntary Disclosure Program “Bait and Switch” May Undermine Trust For The IRS and Future Compliance Programs*, *supra*. For a discussion of FBAR penalty issues see Most Serious Problem, *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*, *supra*.

<sup>63</sup> 135 T.C. 70 (2010).

<sup>64</sup> IRC § 7623 authorizes the payment of awards from the proceeds of amounts the Government collects by reason of the information provided by a whistleblower.

<sup>65</sup> *Cooper v. Comm'r*, 135 T.C. 70 (2010) at 72.

<sup>66</sup> *Cooper v. Comm'r*, at 75 (citation omitted).

<sup>67</sup> *Id.*

<sup>68</sup> The government subsequently filed a motion for summary judgment, which the Tax Court granted. See *Cooper v. Comm'r*, 136 T.C. No. 30 (2011). It reasoned that because the IRS did not collect any amounts by reason of the information provided by Mr. Cooper, he was not entitled to a whistleblower award. *Id.*

**In *Friedland v. Commissioner*, the Tax Court held that it lacked jurisdiction to review the IRS’s denial of a whistleblower claim because the whistleblower did not file a timely petition, even though the filing may have been delayed because the Whistleblower Office erroneously advised the whistleblower to file with the Court of Federal Claims.<sup>69</sup>**

In September of 2009, Mr. Friedland submitted a whistleblower claim to the IRS on Form 211, *Application for Award for Original Information*. On November 13, 2009, the IRS Whistleblower Office sent Mr. Friedland a letter, denying the claim. Mr. Friedland followed up by calling the Whistleblower Office and sending additional information. This prompted the Whistleblower Office to send him three more letters, one of which advised that to challenge its decision he could “write to the US Court of Claim (sic). . . .”<sup>70</sup> The other letters from the Whistleblower Office were duplicates, confirming that it received and considered the additional information, but that its initial determination remained the same. Mr. Friedland filed a complaint in the Court of Federal Claims, as suggested by the Whistleblower Office. The Court of Federal Claims dismissed the complaint for lack of jurisdiction on May 26, 2010. Mr. Friedland then filed a petition with the Tax Court on June 18, 2010, 217 days after he received the first letter.

The IRS filed a motion to dismiss for lack of jurisdiction, arguing that no determination notice had been issued, or alternatively, if one had been issued, Mr. Friedland failed to file his petition with the Tax Court within the requisite 30-day period following a determination.<sup>71</sup> Relying on *Cooper v. Commissioner*,<sup>72</sup> the court found that the November 13, 2009 letter was the IRS’s determination, which then triggered the requirement in IRC § 7623(b) (4) to file a petition within 30 days. Consequently, the court concluded that it lacked jurisdiction because Mr. Friedland did not file a timely petition.<sup>73</sup> While sympathizing with Mr. Friedland’s reliance on the IRS’s erroneous advice, the court concluded that “estoppel cannot create jurisdiction where none exists.”<sup>74</sup> This case could be significant because it suggests the Tax Court will not apply equitable tolling principles in determining whether a whistleblower’s petition is timely.<sup>75</sup>

<sup>69</sup> T.C. Memo. 2011-90.

<sup>70</sup> *Id.*

<sup>71</sup> IRC § 7623(b)(4) (“Any determination regarding an award . . . may, within 30 days of such determination, be appealed to the Tax Court (and the Tax Court shall have jurisdiction with respect to such matter.)”).

<sup>72</sup> 135 T.C. 70 (2010) (discussed above).

<sup>73</sup> *Friedland*, T.C. Memo. 2011-90.

<sup>74</sup> *Id.* (citation omitted).

<sup>75</sup> For an argument that the Tax Court should have applied equitable tolling, see Carlton M. Smith, *Friedland: Did the Tax Court Blow Its Whistleblower Jurisdiction?*, 131 Tax Notes 843 (May 23, 2011).

MLI  
#1**Summons Enforcement Under Internal Revenue Code Sections 7602, 7604, and 7609****SUMMARY**

The IRS may examine any books, records, or other data relevant to an investigation of a civil or criminal tax liability.<sup>1</sup> To obtain this information, the IRS may serve a summons directly on the subject of the investigation or any third party who may possess relevant information.<sup>2</sup>

A person who has a summons served on him or her may contest its legality if the government petitions a court to enforce it.<sup>3</sup> 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.<sup>4</sup> Generally, the burden on the taxpayer to establish the illegality of the summons is formidable.<sup>5</sup> We identified 132 cases decided between June 1, 2010, and May 31, 2011, that included issues of IRS summons enforcement. The parties contesting the summons prevailed in full in only five of these cases, with six cases resulting in split decisions, and the IRS prevailing in the remaining 121 cases.

**PRESENT LAW**

The IRS has broad authority under IRC § 7602 to issue a summons to examine a taxpayer's books and records or demand testimony under oath.<sup>6</sup> Further, the IRS may obtain information related to an investigation from a third party if, subject to the exceptions of IRC § 7609(c), it provides notice to those identified in the summons.<sup>7</sup> However, the IRS may not issue a summons *after* referring the matter to the Department of Justice (DOJ).<sup>8</sup> If the recipient fails to comply with a summons, the United States may commence an action under IRC § 7604 in the appropriate United States District Court to compel production or testimony.<sup>9</sup> If the United States files a petition to enforce the summons, the taxpayer may contest the validity of the summons in that proceeding.<sup>10</sup> Also, if the summons is served

<sup>1</sup> Internal Revenue Code (IRC) § 7602(a)(1); Treas. Reg. § 301.7602-1.

<sup>2</sup> IRC § 7602(a).

<sup>3</sup> *U.S. v. Powell*, 379 U.S. 48, 58 (1964).

<sup>4</sup> IRC § 7609(b).

<sup>5</sup> *Bodensee Fund, LLC v. U.S. Dept. of Treasury-IRS*, 101 A.F.T.R.2d (RIA) 2092 (E.D. Pa. 2008).

<sup>6</sup> IRC § 7602(a). See also *LaMura v. U.S.*, 765 F.2d 974, 979 (11th Cir. 1985) (citing *U.S. v. Bisceglia*, 420 U.S. 141, 145-46 (1975)).

<sup>7</sup> IRC § 7602(a). Those entitled to notice of a third-party summons (other than the person summoned) must be given notice of the summons within three days of the day on which the summons is served to the third party, but no later than the 23rd day before the day fixed on the summons on which the records will be reviewed. IRC § 7609(a).

<sup>8</sup> IRC § 7602(d). This restriction applies to "any summons, with respect to any person if a [DOJ] referral is in effect with respect to such person." IRC § 7602(d)(1).

<sup>9</sup> IRC § 7604.

<sup>10</sup> *U.S. v. Powell*, 379 U.S. 48, 58 (1964).

upon a third party, any person entitled to notice may initiate a petition to quash the summons in U.S. District Court, or intervene in any proceeding regarding the enforceability of the summons.<sup>11</sup>

A person named in a third party summons is generally entitled to notice,<sup>12</sup> but two exceptions may apply. First, the IRS is not required to give notice if the summons is issued to aid in the collection of “an assessment made or judgment rendered against the person with respect to whose liability the summons is issued.”<sup>13</sup> This exception reflects congressional recognition of a difference between a summons issued in an attempt to compute the taxpayer’s taxable income, and a summons issued after the IRS has made an assessment or obtained a judgment. For example, notice would not be necessary where the IRS has made the assessment and is attempting to determine whether the taxpayer has an account in a certain bank with sufficient funds to pay the tax. Giving taxpayers notice in such a case would seriously impede the IRS’s ability to collect the tax.<sup>14</sup> The courts have interpreted this “aid of collection” exception to apply only where the taxpayer owns a legally identifiable interest in the account or other property for which records are summoned.<sup>15</sup> The second notice exception, also to facilitate tax collection, occurs when an IRS criminal investigator serves a summons on any person who is not the third party record keeper in connection with a criminal investigation.

Regardless of whether the taxpayer contests the summons in a motion to quash or a response to an IRS petition to enforce, the legal standard is the same.<sup>16</sup> In *United States v. Powell*, the Supreme Court set forth four threshold requirements that must be satisfied to enforce an IRS summons:

- The investigation must be conducted for a legitimate purpose;
- The information sought must be relevant to that purpose;
- The IRS must not already possess the information; and
- All required administrative steps must have been taken.<sup>17</sup>

The IRS bears the initial burden of establishing that these requirements have been met.<sup>18</sup> However, this burden is minimal, as the government need only introduce a sworn affidavit of the agent who issued the summons declaring that each of the *Powell* requirements has

<sup>11</sup> IRC § 7609(b). The petition to quash must be filed not later than the 20th day after the date on which notice was served. IRC § 7609(b)(2)(A).

<sup>12</sup> IRC § 7609(a)(1).

<sup>13</sup> IRC § 7609(c)(2)(D)(i). The exception also applies to the collection of a liability of “any transferee or fiduciary of any person referred to in clause (i).” IRC § 7609(c)(2)(D)(ii).

<sup>14</sup> H.R. Rep. No. 94-658 at 310, *reprinted in* 1976 U.S.C.C.A.N. at 3206. See also S. Rep. No. 94-938, pt. 1, at 371-72, *reprinted in* 1976 U.S.C.C.A.N. at 3800-01 (containing essentially the same language).

<sup>15</sup> *Ip v. U.S.*, 205 F.3d 1168, 1172-76 (9th Cir. 2000).

<sup>16</sup> *Phillips v. Comm’r*, 99 A.F.T.R.2d (RIA) 3487 (D. Ariz. 2007).

<sup>17</sup> *U.S. v. Powell*, 379 U.S. 48, 57-58 (1964).

<sup>18</sup> *Fortney v. U.S.*, 59 F.3d 117, 119-20 (9th Cir. 1995).

been satisfied.<sup>19</sup> The burden then shifts to the person contesting the summons to demonstrate that the IRS did not meet the requirements or that enforcement of the summons would be an abuse of process.<sup>20</sup>

A taxpayer may also allege that the information requested is protected by a statutory or common-law privilege, such as the:

- Attorney-client privilege;<sup>21</sup>
- Work-product privilege;<sup>22</sup> or
- Tax practitioner privilege.<sup>23</sup>

However, these privileges are limited. For example, they extend to “tax advice” but not to tax return preparation materials.<sup>24</sup> Another limitation is the “tax shelter” exception, which permits discovery of communications between a tax practitioner and client that promote participation in any tax shelter.<sup>25</sup>

### ANALYSIS OF LITIGATED CASES

Summons enforcement has appeared as a Most Litigated Issue in the National Taxpayer Advocate’s Annual Report to Congress every year since 2005. At that time, we identified only 44 cases but predicted the number would rise as the IRS became more aggressive in its enforcement initiatives. Our prediction was accurate, as the volume of cases increased to 101 in 2006, 109 in 2007, 146 in 2008, and 158 in 2009, before declining to 146 in 2010 and 132 in 2011.<sup>26</sup> A detailed list of this year’s cases appears in Table 1 in Appendix III.

The IRS prevailed in full in 121 cases, taxpayers prevailed in five cases, and six cases resulted in split decisions. Attorneys represented taxpayers in 34 cases, while taxpayers appeared *pro se* (*i.e.*, without counsel) in the other 98. Ninety-five cases involved individual

<sup>19</sup> *U.S. v. Dynavac, Inc.*, 6 F.3d 1407, 1414 (9th Cir. 1993).

<sup>20</sup> *Id.*

<sup>21</sup> The attorney-client privilege generally provides protection from discovery of information where:

(1) legal advice of any kind is sought, (2) from a professional legal advisor in his or her capacity as such, (3) the communication is related to this purpose, (4) made in confidence, (5) by the client, (6) and at the client’s insistence protected, (7) from disclosure by the client or the legal advisor, (8) except where the privilege is waived. *U.S. v. Evans*, 113 F.3d 1457, 1461 (7th Cir. 1997) (citing John Henry Wigmore, *Evidence in Trials at Common Law* § 2292 (John T. McNaughten rev. 1961)).

<sup>22</sup> The work product doctrine protects against the discovery of documents and other tangible materials prepared in anticipation of litigation. Fed. R. Civ. P. 26(b)(3); see also *Hickman v. Taylor*, 329 U.S. 495 (1947).

<sup>23</sup> IRC § 7525 extends the protection of the common law attorney-client privilege to federally authorized tax practitioners in federal tax matters. Criminal tax matters and communications regarding tax shelters are exceptions to the privilege. IRC § 7525(a)(2), (b). The tax practitioner privilege is interpreted based on the common law rules of the attorney-client privilege. *U.S. v. BDO Seidman, LLP*, 337 F.3d 802, 810-12 (7th Cir. 2003), *petition for cert. denied*, *Roes v. U.S.*, 540 U.S. 1178 (2004).

<sup>24</sup> *U.S. v. Frederick*, 182 F.3d 496, 500 (7th Cir. 1999), *petition for cert. denied*, 528 U.S. 1154 (2000).

<sup>25</sup> IRC § 7525(b); *Valero Energy Corp. v. U.S.*, 569 F.3d 626 (7th Cir. 2009).

<sup>26</sup> National Taxpayer Advocate 2010 Annual Report to Congress 428-435; National Taxpayer Advocate 2009 Annual Report to Congress 430-437; National Taxpayer Advocate 2008 Annual Report to Congress 488-494; National Taxpayer Advocate 2007 Annual Report to Congress 588-593; National Taxpayer Advocate 2006 Annual Report to Congress 582-588.

taxpayers, while the remaining 37 involved business taxpayers (21 of whom had representation). The arguments the litigants raised against IRS summonses generally fell into the following categories:

**Powell Requirements:** Taxpayers frequently argued that the IRS did not meet one or more of the *Powell* requirements. However, because the burden on the government to establish its *prima facie*<sup>27</sup> case is minimal, while the burden on the taxpayer is very high, these arguments were generally unsuccessful.<sup>28</sup> We identified only one case in which the taxpayer successfully challenged the government's *prima facie* showing. In *Miccosukee Tribe of Indians of Florida v. United States*,<sup>29</sup> the court rejected many of the taxpayer's objections to the third party summonses the IRS issued. The court held, however, that a hearing was necessary to determine whether the IRS already possessed certain summoned materials and whether the IRS acted in bad faith, and thus lacked a legitimate purpose for the summons.

**Criminal Referral:** As long as a matter has not been referred to DOJ, the IRS may issue summonses for the purpose of investigating a possible criminal offense.<sup>30</sup> Some taxpayers argued that, because the IRS issued the summons pursuant to a possible criminal investigation, it violated the IRC § 7602(d) restriction on issuing a summons after referring the matter to DOJ. However, the courts were careful to distinguish between a *referral* to the DOJ, which prevents the IRS from issuing a summons, and a *criminal investigation* by the IRS, which does not.<sup>31</sup> Additionally, the IRC § 7602(d) restriction on issuing a summons after DOJ referral applies only when the IRS has referred the taxpayer whose tax liabilities are under investigation to the DOJ. This restriction does not apply when summoning a third party whose own tax matter has been referred to the DOJ.<sup>32</sup>

**Constitutional Arguments:** Taxpayers asserted several unsuccessful constitutional arguments. For example, courts have long stated that taxpayers cannot use the Fourth Amendment as a defense against a third party summons.<sup>33</sup> Although the courts also routinely rejected blanket assertions of Fifth Amendment protection,<sup>34</sup> taxpayers may have valid Fifth Amendment claims regarding specific documents or testimony.<sup>35</sup> One court quashed the portion of an IRS summons requesting documents finding that portion of the

<sup>27</sup> "Prima facie" means "at first sight, on first appearance but subject to further review or evidence." *Black's Law Dictionary* (9th ed. 2009).

<sup>28</sup> See, e.g., *United States v. Cathcart*, 409 Fed. Appx. 74 (9th Cir. 2010), *aff'g* D.C. No. 2:07-cv-08395-GHK-SH (C.D. Cal. 2008); *Canatella v. United States*, 107 A.F.T.R.2d (RIA) 1690 (N.D. Cal. 2011); *United States v. Swanson Flo-Systems, Co.*, 107 A.F.T.R.2d (RIA) 2434 (D. Minn. 2011), *adopted by* 107 A.F.T.R.2d (RIA) 2438 (D. Minn. 2011).

<sup>29</sup> 730 F. Supp. 2d 1344 (S.D. Fla. 2010), *appeal dismissed* (11th Cir. May 23, 2011).

<sup>30</sup> See, e.g., *Foust v. United States*, 107 A.F.T.R.2d (RIA) 2178 (N.D. Cal. 2011).

<sup>31</sup> See, e.g., *Kern v. IRS*, 107 A.F.T.R.2d (RIA) 1894 (E.D. Mich. 2011), *adopting* 2007 U.S. Dist. LEXIS 99167 (E.D. Mich. 2007).

<sup>32</sup> *Nova Benefit Plans, LLC v. Comm'r*, 107 A.F.T.R.2d (RIA) 1512 (D. Neb. 2011).

<sup>33</sup> *Moyes v. United States*, 106 A.F.T.R.2d (RIA) 5980 (E.D. Cal. 2010) (citing *Donaldson v. United States*, 400 U.S. 517, 522 (1971)).

<sup>34</sup> *United States v. Roe*, 421 Fed. Appx. 881 (10th Cir. 2011), *aff'g* 107 A.F.T.R.2d (RIA) 2013 (D. Colo. 2010), *motion to stay pending appeal denied by* 107 A.F.T.R.2d (RIA) 2280 (D. Colo. 2010); *United States/IRS v. Lanoie*, 403 Fed. Appx. 328 (10th Cir. 2010), *aff'g* 106 A.F.T.R.2d (RIA) 7213 (D.N.M. 2010).

<sup>35</sup> *United States v. Shadley*, 106 A.F.T.R.2d (RIA) 5440 (E.D. Cal. 2010).

summons “extremely broad.” The court then ordered the government to issue a narrower summons, limited to documents in which the taxpayer’s possession was a foregone conclusion.<sup>36</sup> Fifth Amendment rights are not applicable to a taxpayer contesting a third party summons because the Fifth Amendment only protects against compelled self incrimination, not testimony by others.<sup>37</sup> Courts have also rejected taxpayers’ arguments asserting a violation of the taxpayers’ First Amendment rights

**Privilege:** Courts generally rejected blanket claims of attorney-client privilege. In *United States v. Richey*,<sup>38</sup> the Ninth Circuit reversed a decision by the district court holding that the attorney-client privilege protected the work file related to the appraisal of a conservation easement. The taxpayers were required to obtain this appraisal in order to claim a charitable deduction for the value of the easement. The Ninth Circuit found that any communication related to the appraisal was not made for the purpose of providing legal advice, but, instead, for the purpose of determining the value of the easement and thus not subject to the attorney-client privilege or the work-product doctrine. In *United States v. Trenk*,<sup>39</sup> the Third Circuit remanded the case back to the district court so that the taxpayer could argue that the crime-fraud exception to attorney-client privilege did not apply to certain documents.<sup>40</sup>

The identity of a taxpayer’s client is not protected by the attorney-client privilege unless revealing such evidence would be “tantamount to [disclosing] a confidential communication.”<sup>41</sup> Similarly, bank records pertaining to an attorney’s client trust accounts are not protected by the attorney-client privilege.<sup>42</sup>

In addition to attorney-client privilege, taxpayers may use the tax practitioner privilege under IRC § 7525 or work-product privilege as defenses to summons enforcement. The tax practitioner privilege exists to the extent the communication would be considered privileged if it took place between a taxpayer and an attorney and its purpose was obtaining tax advice from a federally authorized tax practitioner.<sup>43</sup> The privilege does not, however, apply to communication in connection with the promotion of the direct or indirect participation

<sup>36</sup> *United States v. Stevenson*, 107 A.F.T.R.2d (RIA) 1928 (D. Minn. 2011), *adopting in part, rejecting in part* 2010 U.S. Dist. LEXIS 142775 (D. Minn. 2010), *appeal dismissed* (8th Cir. July 7, 2011).

<sup>37</sup> *Moyes v. United States*, 106 A.F.T.R.2d (RIA) 5980 (E.D. Cal. 2010).

<sup>38</sup> 632 F.3d 559 (9th Cir. 2011), *rev'g* 103 A.F.T.R.2d (RIA) 1228 (D. Idaho 2009).

<sup>39</sup> 385 Fed. Appx. 254 (3d Cir. 2010) *remanded to* 107 A.F.T.R.2d (RIA) 1633 (D.N.J. 2011) *adopted in part, rejected in part by* 107 A.F.T.R.2d (RIA) 1634 (D.N.J. 2011).

<sup>40</sup> The crime-fraud exception may override the attorney-client privilege. The party seeking the exception must show that “(1) the client was committing or intending to commit a fraud or crime, and (2) the attorney-client communications were in furtherance of that alleged crime or fraud.” *United States v. Trenk*, 385 Fed. Appx. 254, 258 (citation omitted) (citing *In re Grand Jury Subpoena*, 223 F.3d 213, 217 (3d Cir. 2000)).

<sup>41</sup> *Sears v. United States*, 392 Fed. Appx. 605 (9th Cir. 2010) (citing *United States v. Blackmun*, 72 F.3d 1418, 1424 (9th Cir. 1985)).

<sup>42</sup> *Gjerde v. United States*, 107 A.F.T.R.2d (RIA) 1798 (E.D. Cal. 2011), *adopted by* 2011 U.S. Dist. LEXIS 50793 (E.D. Cal. 2011).

<sup>43</sup> IRC § 7525(a)(1). See *Pasadena Ref. Sys, Inc. v. United States*, 107 A.F.T.R.2d (RIA) 2300 (N.D. Tex. 2011), *adopted by* 107 A.F.T.R.2d (RIA) 2303 (N.D. Tex. 2011), *appeal dismissed* (5th Cir. Sept. 27, 2011) (applying attorney-client and tax practitioner privilege to communications between firm and its corporate client, but not to petitioner’s internal documents).

of a taxpayer in any tax shelter.<sup>44</sup> Under the tax shelter exception, the tax practitioner privilege does not apply to any written communication between a federally authorized tax practitioner and “any person, any director, officer, employee, agent, or representative of the person, or any other person holding a capital or profits interest in the person” and “in connection with the promotion of the direct or indirect participation of the person in any tax shelter.”<sup>45</sup> A tax shelter is defined as “a partnership or any other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of Federal income tax.”<sup>46</sup>

The IRS prevailed in 38 of the 44 cases involving motions to quash summonses, in part because the courts lacked jurisdiction to hear the cases. The courts dismissed these cases for lack of jurisdiction for the following reasons:

**Lack of Jurisdiction Due to Procedural Requirements:** The United States is immune from suit unless Congress has expressly waived its sovereign immunity.<sup>47</sup> Since a motion to quash service of an IRS summons is a suit against the United States, a court has jurisdiction only when Congress has expressly waived sovereign immunity.<sup>48</sup> When a taxpayer wishes to challenge an IRS summons issued to a third party, federal law sets forth the exclusive method by which a taxpayer may proceed.<sup>49</sup> A taxpayer may initiate a proceeding in the U.S. District Court in which the third party resides, no later than 20 days from the date the notice of summons was given.<sup>50</sup> Accordingly, the courts have strictly construed IRC § 7609 when determining if sovereign immunity has been waived.<sup>51</sup> For example, a court dismissed a *pro se* taxpayer’s motion to quash for lack of jurisdiction because the taxpayer filed the motion nine days after the 20-day limitation had expired.<sup>52</sup> Another court held that it lacked subject matter jurisdiction over a petition to quash a third-party tax summons, where the third party neither resided nor was found within jurisdiction of the district court.<sup>53</sup> Courts have also dismissed motions to quash because the IRS had not yet attempted to enforce an administrative summons.<sup>54</sup>

**Lack of jurisdiction due to notice requirements:** Courts denied several motions to quash because the parties contesting the summonses were not entitled to notice of the summonses due to one of the IRC § 7609(c) exceptions, and therefore lacked standing to contest

<sup>44</sup> IRC § 7525(b).

<sup>45</sup> *Id.*

<sup>46</sup> IRC § 6662(d)(2)(C)(ii).

<sup>47</sup> *U.S. v. Dalm*, 494 U.S. 596, 608 (1990).

<sup>48</sup> *Kasian v. IRS*, 106 A.F.T.R.2d (RIA) 7274 (D. Ariz. 2010).

<sup>49</sup> IRC § 7609(b)(2)(A). See *Felt v. Mondfrans*, 107 A.F.T.R.2d (RIA) 621 (D. Utah 2011).

<sup>50</sup> IRC § 7609(b)(2)(A); *Williams v. United States*, 107 A.F.T.R.2d (RIA) 1453 (N.D. Tex. 2011), *appeal reinstated* (5th Cir. June 20, 2011).

<sup>51</sup> *Ellis v. Comm’r*, 107 A.F.T.R.2d (RIA) 1450 (S.D. Cal. 2011).

<sup>52</sup> *Id.*

<sup>53</sup> *Deems v. United States*, 2010 U.S. Dist. LEXIS 141127 (S.D. Ga. 2010), *adopted by* 2011 U.S. Dist. LEXIS 11706 (S.D. Ga. 2011)

<sup>54</sup> *Woodruff v. U.S. Dept. of Treas.*, 106 A.F.T.R.2d (RIA) 5105 (D. Utah 2010).

the validity of the summonses.<sup>55</sup> In *Nelson v. IRS*,<sup>56</sup> for instance, the court dismissed a taxpayer's challenge to a summons issued to his corporation because the taxpayer, as an individual, lacked standing to bring such a challenge.

## CONCLUSION

The IRS may issue a summons to obtain information needed to determine whether a tax return is correct or if a return should have been filed, to ascertain a taxpayer's tax liability, or collect a liability.<sup>57</sup> Accordingly, the IRS may request documents and testimony from taxpayers who have failed to provide that information voluntarily. Taxpayers and third parties rarely succeed in contesting IRS summonses due to the significant burden of proof and strict procedural requirements. It appears that as the IRS employs a more aggressive enforcement policy, it will continue to rely heavily on the summons enforcement tool, and the courts will continue to see these cases.

<sup>55</sup> IRC § 7609(c)(2)(D)(i); *Kirkland v. IRS*, 106 A.F.T.R.2d (RIA) 6962 (D. Nev. 2010), *adopting* 106 A.F.T.R.2d (RIA) 6960 (D. Nev. 2010).

<sup>56</sup> 107 A.F.T.R.2d (RIA) 403 (E.D. Pa. 2011).

<sup>57</sup> IRC § 7602(a).

MLI  
#2**Trade or Business Expenses Under Internal Revenue Code  
Section 162 and Related Sections****SUMMARY**

The deductibility of trade or business expenses is perennially among the ten Most Litigated Issues. We identified 107 cases involving a trade or business expense issue that were litigated between June 1, 2010, and May 31, 2011. The courts affirmed the IRS position in the majority (approximately 53 percent) of cases, while taxpayers prevailed about seven percent of the time.<sup>1</sup> The remaining cases resulted in split decisions.

**PRESENT LAW**

Internal Revenue Code (IRC or the “Code”) § 162 allows deductions for ordinary and necessary trade or business expenses paid or incurred during the course of a taxpayer’s taxable year. Rules regarding the practical application of IRC § 162 have evolved largely from case law and administrative guidance. The IRS, the Department of the Treasury, Congress, and the courts continue to provide legal guidelines about whether a taxpayer is entitled to certain deductions. The cases analyzed for this report illustrate that this process is ongoing and involves the analysis of facts and circumstances. When a taxpayer seeks judicial review of the IRS’s determination of a tax liability stemming from the deductibility of a particular trade or business expense, the courts must often address a series of questions, including those discussed below.

**What is a trade or business expense under IRC § 162?**

Although “trade or business” is one of the most widely used terms in the IRC, neither the Code nor the Treasury Regulations provide a definition.<sup>2</sup> The definition of a “trade or business” comes from common law, where the concepts have been developed and refined by the courts.<sup>3</sup> The Supreme Court has interpreted “trade or business” for purposes of IRC § 162 to mean an activity conducted “with continuity and regularity” and with the primary purpose of earning income or making a profit.<sup>4</sup>

**What is an ordinary and necessary expense?**

IRC § 162(a) requires a trade or business expense to be both “ordinary and necessary” in relation to the taxpayer’s trade or business in order to be deductible. In *Welch v. Helvering*, the Supreme Court stated that the words “ordinary” and “necessary” have different meanings, both of which must be satisfied for a taxpayer to benefit from the deduction.<sup>5</sup> The

<sup>1</sup> The IRS prevailed in full in 57 of the 107 cases, while taxpayers prevailed in full in only eight cases.

<sup>2</sup> In 1986, the term “trade or business” appeared in at least 492 subsections of the Code and 664 Treasury Regulations. See F. Ladson Boyle, *What Is a Trade or Business?* 39 Tax Law. 737 (Summer 1986).

<sup>3</sup> Carol Duane Olson, *Toward a Neutral Definition of “Trade or Business” in the Internal Revenue Code*, 54 U. Cin. L. Rev. 1199 (1986).

<sup>4</sup> *Comm’r v. Groetzinger*, 480 U.S. 23, 35 (1987).

<sup>5</sup> 290 U.S. 111, 113 (1933).

Supreme Court describes an “ordinary” expense as customary or usual and of common or frequent occurrence in the taxpayer’s trade or business.<sup>6</sup> The Court describes a “necessary” expense as one that is appropriate and helpful for development of the business.<sup>7</sup>

Common law also requires that in addition to being ordinary and necessary, the amount of the expense must be reasonable for the expense to be deductible. In *Commissioner v. Lincoln Electric Co.*, the Court of Appeals for the Sixth Circuit held “the element of reasonableness is inherent in the phrase ‘ordinary and necessary.’ Clearly it was not the intention of Congress to automatically allow as deductions operating expenses incurred or paid by the taxpayer in an unlimited amount.”<sup>8</sup>

#### **Is the expense a currently deductible expense or a capital expenditure?**

A currently deductible expense is an ordinary and necessary expense that is paid or incurred during the taxable year in the course of carrying on a trade or business.<sup>9</sup> No deductions are allowed for the cost of acquisition, construction, improvement, or restoration of an asset that is expected to last more than one year.<sup>10</sup> Instead, capital expenditures may be subject to amortization, depletion, or depreciation over the useful life of the property.<sup>11</sup>

Determining whether to deduct expenditures under IRC § 162(a) or to capitalize them under IRC § 263 is a question of fact. Courts have adopted a case-by-case approach to applying principles of capitalization and deductibility.<sup>12</sup>

#### **When is an expense paid or incurred during the taxable year, and what proof is there that the expense was paid?**

IRC § 162(a) requires an expense to be “paid or incurred during the taxable year” to be deductible. The Code also requires a taxpayer to maintain books and records that substantiate income, deductions, and credits—including adequate records to substantiate deductions claimed as trade or business expenses.<sup>13</sup> If a taxpayer cannot substantiate exact amounts of deductions by documentary evidence (*e.g.*, invoice, paid bill, or canceled check) but can establish nonetheless that he or she had some business expenditures, the courts may employ the *Cohan* rule to grant the taxpayer a reasonable amount of deductions.

The *Cohan* rule is one of “indulgence” established in 1930 by the Court of Appeals for the Second Circuit in *Cohan v. Commissioner*.<sup>14</sup> The court held that the taxpayer’s business

<sup>6</sup> *Deputy v. du Pont*, 308 U.S. 488, 495 (1940) (citation omitted).

<sup>7</sup> *Comm’r v. Tellier*, 383 U.S. 687, 689 (1966) (citations omitted).

<sup>8</sup> 176 F.2d 815, 817 (6th Cir. 1949), *cert. denied*, 338 U.S. 949 (1950).

<sup>9</sup> IRC § 162(a).

<sup>10</sup> IRC § 263. See also *INDOPCO, Inc. v. Comm’r*, 503 U.S. 79 (1992).

<sup>11</sup> IRC § 167.

<sup>12</sup> See *PNC Bancorp, Inc. v. Comm’r*, 212 F.3d 822 (3d Cir. 2000); *Norwest Corp. v. Comm’r*, 108 T.C. 265 (1997).

<sup>13</sup> IRC § 6001. See also Treas. Reg. §§ 1.6001-1 and 1.446-1(a)(4).

<sup>14</sup> 39 F.2d 540 (2d Cir. 1930).

expense deductions were not adequately substantiated, but “the [Tax Court] should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. But to allow nothing at all appears to us inconsistent with saying that something was spent.”<sup>15</sup>

The *Cohan* rule may not be utilized in situations where IRC § 274(d) applies. Section 274(d) provides that unless a taxpayer complies with strict substantiation rules, no deductions are allowable for:

1. Travel expenses;
2. Entertainment, amusement, or recreation expenses;
3. Gifts; or
4. Certain “listed property.”<sup>16</sup>

A taxpayer must substantiate a claimed IRC § 274(d) expense with adequate records or sufficient evidence to corroborate the taxpayer’s statement establishing the amount, time, place, and business purpose of the expense.<sup>17</sup>

#### Who has the burden of proof in a substantiation case?

Generally, the taxpayer bears the burden of proving that he or she is entitled to the business expense deductions and the IRS’s proposed determination of tax liability is incorrect.<sup>18</sup> IRC § 7491(a) provides that the burden of proof shifts to the IRS when a taxpayer:

- Introduces credible evidence with respect to any factual issue relevant to ascertaining the taxpayer’s liability;
- Complies with the requirements to substantiate deductions;
- Maintains all records required under the Code; and
- Cooperates with reasonable requests by the IRS for witnesses, information, documents, meetings, and interviews.<sup>19</sup>

### ANALYSIS OF LITIGATED CASES

Trade or business expenses have been one of the ten Most Litigated Issues since the first edition of the National Taxpayer Advocate’s Annual Report to Congress in 1998.<sup>20</sup> In this

<sup>15</sup> 39 F.2d 540, 544 (2d Cir. 1930).

<sup>16</sup> “Listed property” means any passenger automobile; any property used as a means of transportation; any property of a type generally used for purposes of entertainment, recreation, or amusement; any computer or peripheral equipment (except when used exclusively at a regular business establishment and owned or leased by the person operating such establishment); and any other property specified by regulations. IRC § 280F(d)(4)(A) and (B).

<sup>17</sup> Treas. Reg. § 1.274-5T(b).

<sup>18</sup> See *Welch v. Helvering*, 290 U.S. 111, 115 (1933) (citations omitted) and U.S. Tax Court Rules of Practice and Procedure, Rule 142(a).

<sup>19</sup> IRC § 7491(a)(1) applies to a court proceeding in which the examination started after July 22, 1998, and if there is no examination, to the taxable period or events which started or occurred after July 22, 1998.

<sup>20</sup> See National Taxpayer Advocate 1998-2010 Annual Reports to Congress.

year's report, we reviewed 107 cases involving trade or business expense issues that were litigated in federal courts from June 1, 2010, through May 31, 2011. Table 2 in Appendix III contains a list of the main issues in those cases. Table 3.2.1 (below) categorizes the main issues raised by taxpayers. Cases involving more than one issue are included in more than one category.

**TABLE 3.2.1, Trade or Business Expense Issues in Cases Reviewed**

| Issue  | Type of Taxpayer |   |
|--|------------------|---|
|  | Individual       | Business (including sole proprietorships) |
| Substantiation of expenses, including application of the <i>Cohan</i> rule <sup>21</sup> | 24               | 55  |
| Profit objective <sup>22</sup>   | 0                | 6   |
| Ordinary and necessary trade or business expenses <sup>23</sup>                          | 2                | 3   |
| Personal vs. business expenses <sup>24</sup>   | 4                | 9   |
| Business expenses vs. capital expenditures <sup>25</sup>                                 | 0                | 1   |
| Education expenses <sup>26</sup>   | 0                | 3   |
| Did the taxpayer establish the carrying on of a trade or business?                       | 0                | 7   |
| Gambling expenses <sup>27</sup>  | 0                | 2   |

Approximately 71 percent of the taxpayers litigating trade or business deduction issues represented themselves (*pro se*). Taxpayers represented by counsel fared noticeably better than their *pro se* counterparts. Taxpayers with representation received full or partial relief in approximately 58 percent of litigated cases (18 of 31), while *pro se* taxpayers received partial relief in approximately 34 percent of litigated cases (26 of 76). Only four *pro se* taxpayers received full relief.

<sup>21</sup> IRC § 6001 and Treas. Reg. § 1.6001-1 require a taxpayer to maintain books and records that substantiate income, deductions, and credits. Treas. Reg. § 1.162-17 provides guidance regarding maintaining adequate records to substantiate deductions claimed as trade or business expenses in connection with the performance of services as an employee. The *Cohan* rule allows courts to estimate certain expenses not properly substantiated. See *Cohan v. Comm'r*, 39 F.2d 540, 544 (2d Cir. 1930).

<sup>22</sup> IRC § 183(a) provides that no deduction attributable to an activity engaged in by an individual or an S corporation shall be allowed if such activity is not engaged in for profit.

<sup>23</sup> IRC § 162(a) allows deductions for ordinary and necessary trade or business expenses paid or incurred during the taxable year.

<sup>24</sup> IRC § 262(a) provides that personal, living, and family expenses are generally not deductible.

<sup>25</sup> Under IRC § 263(a), generally no deduction is allowed for capital expenditures, where capital expenditures include any amount paid for permanent improvements made to increase the value of any property. Under IRC § 195(a), start-up expenditures generally cannot be deducted unless a taxpayer makes an expense/amortization election according to IRC § 195(b). Taxpayers who make the election may generally deduct up to \$5,000 of start-up expenditures in the tax year in which an active trade of business begins and amortize any excess over 180 months. The \$5,000 deduction is reduced by a dollar for every dollar that total start-up expenditures exceed \$50,000. See IRC § 195(b)(1)(A), (B).

<sup>26</sup> Treas. Reg. § 1.162-5(a) provides that a taxpayer may deduct educational expenses under IRC § 162(a) if the education maintains or improves skills required by the individual in his or her employment or other trade or business, or meets the express requirements of the individual's employer.

<sup>27</sup> IRC § 165(d) provides that "[l]osses from wagering transactions shall be allowed only to the extent of the gains from such transactions."

### Individual Taxpayers

None of the 28 decisions involving individual taxpayers (where the term “individual” excludes a sole proprietorship) was issued as a regular opinion of the Tax Court.<sup>28</sup> Of the 28 cases litigated by individual taxpayers, all but 11 appeared *pro se*. Two individual taxpayers received full relief, and 13 of the individual cases resulted in split decisions. The most prevalent issue was the substantiation of claimed trade or business expense deductions, which appeared in 24 cases. For example, in *Forrest v. Commissioner*,<sup>29</sup> the Tax Court denied several deductions claimed by the taxpayer for lack of substantiation, including telephone and litigation fees, meals, and automobile expenses. With respect to the telephone and litigation fees, the court found the taxpayer had not properly substantiated the items and there was not sufficient evidence to provide an estimate under the *Cohan* rule. The meals and automobile expenses were denied because the Tax Court found the taxpayer had not complied with the strict substantiation requirements of IRC § 274(d).

Even in cases where a taxpayer maintains records to substantiate a deduction, the taxpayer still has to prove that the expense in question was paid during the tax year. For example, in *Pendergraft v. United States*,<sup>30</sup> the issue was whether the taxpayers, a husband and wife, had properly substantiated commission expenses paid in their furniture business. Although the taxpayers kept a log to record their expenses, the IRS maintained that they had not proven the disputed fees were actually paid for services rendered, and so they could not be deducted as business expenses. The taxpayers and the government filed motions for summary judgment, and the court concluded that there was not sufficient evidence for either party to carry its burden of demonstrating that summary judgment was appropriate, and therefore denied each party’s motion.

A prevalent issue in cases involving individual taxpayers was expenses for travel to participate in employment away from home. IRC § 162(a)(2) allows a taxpayer to deduct ordinary and necessary travel expenses, including meals and lodging, paid or incurred while away from home in pursuit of a trade or business. The word “home” for this purpose means a taxpayer’s “tax home.”<sup>31</sup> In general, an individual’s tax home is the vicinity of his or her principal place of employment, not his or her residence, if the residence is different from the principal place of employment.<sup>32</sup> An exception to the general rule is where a taxpayer accepts temporary, rather than indefinite, employment away from his or her personal

<sup>28</sup> Tax Court decisions fall into three categories: regular decisions, memorandum decisions, and small tax case (“S”) decisions. The regular decisions of the Tax Court include cases which have some new or novel point of law, or in which there may not be general agreement, and therefore have the most legal significance. In contrast, memorandum decisions generally involve fact patterns within previously settled legal principles and therefore are not as significant. Finally, “S” case decisions (for disputes involving \$50,000 or less) are not appealable and, thus, have no precedential value. See IRC § 7463(b). See also U.S. Tax Court Rules of Practice and Procedure, Rules 170-175. All but nine of the cases involving individual taxpayers (excluding sole proprietorships) were “S” cases.

<sup>29</sup> T.C. Memo. 2010-263.

<sup>30</sup> 94 Fed. Cl. 79 (2010), *appeal dismissed*, 2011 U.S. App. LEXIS 10987 (Fed. Cir. Apr. 27, 2011).

<sup>31</sup> *Mitchell v. Comm’r*, 74 T.C. 578, 581 (1980) (citations omitted).

<sup>32</sup> *Id.*

residence; in that situation, the taxpayer's residence may be the "tax home."<sup>33</sup> Several related cases involved Filipino teachers hired through a State Department exchange program.<sup>34</sup> In these cases, the deductions for living expenses were denied because the employment was determined to be "indefinite" rather than "temporary."<sup>35</sup>

### Business Taxpayers

Seventy-nine cases involved business taxpayers, who had less success than individual taxpayers in obtaining a favorable outcome. Business taxpayers received full or partial relief in approximately 42 percent of cases (33 of 79) compared to 54 percent for individuals (15 of 28). In other words, individual taxpayers were approximately 28 percent more likely than business taxpayers to obtain full or partial relief. In fewer than half of the favorably decided cases, business taxpayers were represented by counsel.

As with individual taxpayers, substantiation of expenses was by far the most prevalent issue,<sup>36</sup> and in some instances the courts denied business taxpayers' deductions for failure to substantiate.<sup>37</sup> On the other hand, courts allowed business taxpayers' trade or business expense deductions that were properly substantiated.<sup>38</sup> There were also business cases where the courts allowed the use of the *Cohan* rule to estimate expenses when documentation was present but incomplete.<sup>39</sup>

Another common question for business taxpayers was whether the deductions were attributable to a legitimate "for profit" activity constituting an actual trade or business. In *Dennis v. Commissioner*,<sup>40</sup> the taxpayers, a husband and wife, raised horses at a substantial financial loss. However, the taxpayers kept separate books and accounts for the horse breeding activity, and took steps to reduce costs over time. Even though the horse breeding activity did not actually produce a profit, it was engaged in with that aim in mind, and so qualified as a "trade or business" eligible for deductions under IRC § 162(a). Conversely, in *DKD Enterprises, Inc. v. Commissioner*,<sup>41</sup> the taxpayers (two business partners) were found to have raised cats for personal pleasure rather than profit. The taxpayers expended large amounts of time and money on the activity that had previously been a hobby, but sold very few cats to offset those costs.

<sup>33</sup> *Peurifoy v. Comm'r*, 358 U.S. 59, 60 (1958).

<sup>34</sup> *Malazarte v. Comm'r*, T.C. Summ. Op. 2010-168; *Abiog v. Comm'r*, T.C. Summ. Op. 2010-166; *Samaco v. Comm'r*, T.C. Summ. Op. 2010-165; *Ucol-Cobaria v. Comm'r*, T.C. Summ. Op. 2010-162. All of these cases were "S" cases, with no precedential value, but they do illustrate the confusion taxpayers face in determining what is their "tax home."

<sup>35</sup> For purposes of IRC § 162(a)(2), the taxpayer is not treated as being temporarily away from home if the period of employment exceeds one year.

<sup>36</sup> Substantiation of expenses issue appeared in 55 of 79 cases involving business taxpayers.

<sup>37</sup> See, e.g., *Coury v. Comm'r*, T.C. Memo. 2010-132; *Griffin v. Comm'r*, T.C. Memo. 2010-252.

<sup>38</sup> See, e.g., *Stewart v. Comm'r*, T.C. Memo. 2010-184.

<sup>39</sup> See, e.g., *Jenkins v. Comm'r*, T.C. Memo. 2010-251; *Stroff v. Comm'r*, T.C. Memo. 2011-80.

<sup>40</sup> T.C. Memo. 2010-216.

<sup>41</sup> T.C. Memo. 2011-29, *appeal docketed*, No. 11-2526 (8th Cir. July 11, 2011).

One significant development in the trade or business arena involved IRC § 165. Typically there are no limits on ordinary and necessary business deductions, but IRC § 165(d) limits deductions for gambling losses to the extent of winnings. Until recently, the Tax Court had interpreted this limitation as applying to both wagering losses and gambling expenses other than wagering losses (*e.g.*, cost of traveling to a casino).<sup>42</sup> Earlier this year, however, the Tax Court reconsidered the issue in *Mayo v. Commissioner*<sup>43</sup> and reached a different result with regard to gambling expenses other than wagering losses. In *Mayo*, the taxpayer was a professional gambler and argued that the limitation of IRC § 165(d) only applied to his wagering losses and did not encompass the other business expenses he incurred in carrying on his professional gambling activities, and as a result, those other business expenses should be fully deductible under IRC § 162. The Tax Court held that expenses in support of professional gambling that were not made as wagers could be deducted under IRC § 162(a) without the limitation of § 165(d), while actual wagering expenses are still subject to the § 165(d) limit.

Other business cases of interest included *Fresenius Medical Care Holdings, Inc. v. United States*,<sup>44</sup> where a district court held that civil damages paid to the government in settlement of a violation of the False Claims Act did not qualify as ordinary and necessary business expenses under IRC § 162(a), and *Media Space, Inc. v. Commissioner*,<sup>45</sup> in which the Tax Court held that forbearance payments renegotiated yearly did not constitute a reacquisition of stock under IRC § 162(k), and therefore were deductible as ordinary and necessary business expenses and not prohibited by IRC § 162(k).<sup>46</sup>

## CONCLUSION

Taxpayers continue to challenge the IRS's denials of trade or business deductions. From June 1, 2010, through May 31, 2011, those taxpayers who were represented fared significantly better than those who represented themselves. While the IRS generally prevailed, the courts did not always favor the IRS's application of the law to the taxpayers' facts and circumstances. Thus, the issue of what constitutes an allowable trade or business expense remains open to interpretation and is highly fact-specific.

Many of these cases demonstrate taxpayer confusion over the legal requirements, especially those in IRC § 274(d) relating to strict substantiation of listed items. The IRS can minimize litigation by providing clear guidance on the deductibility of trade or business expenses. Through education, outreach, and collaboration with stakeholders, the IRS can help taxpayers understand what trade or business deductions are allowable and how to substantiate them. The IRS will encourage compliance and minimize litigation by helping self-employed and small business taxpayers understand these requirements.

<sup>42</sup> See *Offutt v. Comm'r*, 16 T.C. 1214 (1951) (construing § 23(h) of the 1939 Code, a predecessor of current IRC § 165(d) with identical language).

<sup>43</sup> 136 T.C. 81 (2011).

<sup>44</sup> 106 A.F.T.R.2d (RIA) 5028 (D. Mass. 2010).

<sup>45</sup> 135 T.C. 424 (2010), appeal docketed (2nd Cir. May 24, 2011).

<sup>46</sup> IRC § 162(k) prohibits a deduction for an amount paid or incurred by a corporation in connection with a reacquisition of its stock.

MLI  
#3Appeals From Collection Due Process Hearings Under Internal  
Revenue Code Sections 6320 and 6330

## SUMMARY

Collection Due Process (CDP) hearings were created by the IRS Restructuring and Reform Act of 1998 (RRA 98).<sup>1</sup> 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 the collection action, collection alternatives, spousal defenses, and under certain circumstances, the underlying tax liability.<sup>2</sup>

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.<sup>3</sup> Generally, the IRS suspends levy actions during a levy hearing and any judicial review that may follow.<sup>4</sup>

Since 2003, CDP has been one of the federal tax issues most frequently litigated in the federal courts and analyzed for the National Taxpayer Advocate's Annual Report to Congress. The trend continues this year, with the courts issuing 89 opinions during the review period of June 1, 2010, through May 31, 2011.<sup>5</sup> Of these 89 cases, taxpayers prevailed in full in three and in part in three others (approximately seven percent).<sup>6</sup> Of the six cases in which the courts found for the taxpayer in whole or in part, the taxpayers appeared *pro se* (without counsel) in three cases,<sup>7</sup> and were represented in the three others.<sup>8</sup> The cases discussed below demonstrate that CDP serves an important function by providing taxpayers with a forum to raise legitimate issues before the IRS deprives them of property. Many of these decisions provide guidance on substantive issues. Where taxpayers attempted to use the

<sup>1</sup> RRA 98, Pub. L. No. 105-206, § 3401, 112 Stat. 685, 746 (1998).

<sup>2</sup> Internal Revenue Code (IRC) §§ 6320(c) (lien) and 6330(c) (levy). IRC § 6320(c) generally requires Appeals to follow the levy hearing procedures under IRC § 6330 for the conduct of the lien hearing, the review requirements, and the balancing test.

<sup>3</sup> IRC § 6330(d) (setting forth the time requirements for obtaining judicial review of Appeals' determination); IRC §§ 6320(a)(3)(B) and 6330(a)(3)(B) (setting forth the time requirements for requesting a CDP hearing for lien and levy matters, respectively).

<sup>4</sup> IRC § 6330(e)(1) provides that generally, levy actions are suspended during the CDP process (along with a corresponding suspension in the running of the limitations period for collecting the tax). However, IRC § 6330(e)(2) allows the IRS to resume levy actions during judicial review upon a showing of "good cause," if the underlying tax liability is not at issue.

<sup>5</sup> For a list of all of the cases reviewed, see Appendix III, *infra*.

<sup>6</sup> *Byk v. Comm'r*, T.C. Summ. Op. 2010-137, *Dalton v. Comm'r*, 135 T.C. 393 (2010), *appeal docketed* (1st Cir. Oct. 12, 2011), and *Alessio Azzari, Inc. v. Comm'r*, 136 T.C. 178 (2011).

<sup>7</sup> *Byk v. Comm'r*, T.C. Summ. Op. 2010-137, *Malone v. Comm'r*, T.C. Summ. Op. 2011-24, and *Thornberry v. Comm'r*, 136 T.C. 356 (2011).

<sup>8</sup> *Dalton v. Comm'r*, 135 T.C. 393 (2010), *appeal docketed* (1st Cir. Oct. 12, 2011), *Orian v. Comm'r*, T.C. Memo. 2010-234, and *Alessio Azzari, Inc. v. Comm'r*, 136 T.C. 178 (2011).

process inappropriately, courts imposed sanctions or warned taxpayers that they might face sanctions in the future.

## PRESENT LAW

Current law provides taxpayers an opportunity for independent review of an NFTL filed by the IRS, or of a proposed levy action.<sup>9</sup> As noted above, the purpose of CDP rights is to give taxpayers adequate notice of IRS collection activity and a meaningful hearing before the IRS deprives them of property.<sup>10</sup> The hearing allows taxpayers an opportunity to raise issues relating to the collection of the tax liability, including:

- Appropriateness of collection actions;<sup>11</sup>
- Collection alternatives such as an installment agreement (IA), offer in compromise (OIC), posting a bond, or substitution of other assets;<sup>12</sup>
- Appropriate spousal defenses;<sup>13</sup>
- The existence or amount of the underlying tax liability, but only if the taxpayer did not receive a notice of deficiency or otherwise have an opportunity to dispute the liability;<sup>14</sup> and
- Any other relevant issue relating to the unpaid tax, the NFTL, or the proposed levy.<sup>15</sup>

A taxpayer cannot raise an issue considered at a prior administrative or judicial hearing if the individual participated meaningfully in that hearing or proceeding.<sup>16</sup>

### Procedural Collection Due Process Requirements

The IRS must provide a CDP notice to the taxpayer after it has filed the first NFTL or generally before its first intended levy for the particular tax and tax period.<sup>17</sup> The IRS must provide the notice not more than five business days after the day of filing the lien notice, or at

<sup>9</sup> IRC §§ 6320 and 6330. See RRA 98, Pub. L. No. 105-206, § 1001(a), 112 Stat. 685 (1998).

<sup>10</sup> Prior to RRA 98, the U.S. Supreme Court had held that a post-deprivation hearing was sufficient to satisfy due process concerns in the tax collection arena. See *U.S. v. National Bank of Commerce*, 472 U.S. 713, 719-722 (1985); *Phillips v. Comm'r*, 283 U.S. 589, 595-601 (1931).

<sup>11</sup> IRC § 6330(c)(2)(A)(ii).

<sup>12</sup> IRC § 6330(c)(2)(A)(iii).

<sup>13</sup> IRC § 6330(c)(2)(A)(i).

<sup>14</sup> IRC § 6330(c)(2)(B).

<sup>15</sup> IRC § 6330(c)(2)(A); Treas. Reg. §§ 301.6320-1(e) and 301.6330-1(e).

<sup>16</sup> IRC § 6330(c)(4).

<sup>17</sup> IRC § 6330(f) permits the IRS to levy without first giving a taxpayer a CDP notice in the following situations: the collection of tax is in jeopardy, a levy was served on a state to collect on a state tax refund, the levy is a disqualified employment tax levy; or the levy was served on a federal contractor. A disqualified employment tax levy is any levy to collect employment taxes for any taxable period if the person subject to the levy (or any predecessor thereof) requested a CDP hearing with respect to unpaid employment taxes arising in the most recent two-year period before the beginning of the taxable period with respect to which the levy is served. IRC § 6330(h). The federal contractor levy exception was recently added to the exceptions found at IRC § 6330(f). See Pub. L. No. 111-240 § 2104(a), 124 Stat. 2504, 2565 (2010).

least 30 days before the day of the proposed levy.<sup>18</sup> In a lien filing, the notice must inform the taxpayer of his or her right to request a CDP hearing within a 30-day period, which begins on the day after the end of the five-business-day period after the filing of the NFTL.<sup>19</sup> In the case of a levy, the notice must inform the taxpayer of his or her right to request a hearing within the 30-day period beginning on the day after the date on the CDP notice.<sup>20</sup>

### Requesting a CDP Hearing

Under both lien and levy procedures, the taxpayer must return a signed and dated written request for a CDP hearing within the applicable period.<sup>21</sup> Taxpayers who fail to timely request a hearing will be afforded an “equivalent hearing,” which is similar to a CDP hearing, but without judicial review.<sup>22</sup> The Code and regulations require taxpayers to provide their reasons for requesting a hearing. The regulations ask taxpayers to use Form 12153, *Request for a Collection Due Process or Equivalent Hearing*. Failure to provide the basis for the hearing may result in denial of a face-to-face hearing.<sup>23</sup> Taxpayers must request an equivalent hearing within the one-year period beginning the day after the five-business-day period following the filing of the NFTL, or in levy cases, within the one-year period beginning the day after the date of the CDP notice.<sup>24</sup>

### Conduct of a CDP Hearing

The IRS generally will suspend levy action throughout a CDP hearing involving intent to levy, unless it determines the collection of tax is in jeopardy, the collection resulted from a levy on a state tax refund, or the IRS has served a disqualified employment tax levy or a federal contractor levy.<sup>25</sup> The IRS also suspends collection activity throughout any judicial review of Appeals’ determination, unless the underlying tax liability is not at issue and the IRS can demonstrate to the court good cause to resume collection activity.<sup>26</sup>

CDP hearings are informal. When a taxpayer requests a CDP hearing with respect to both a lien and a proposed levy, Appeals will attempt to conduct one hearing.<sup>27</sup> Courts have

<sup>18</sup> IRC § 6320(a)(2) or § 6330(a)(2). The CDP notice can be provided to the taxpayer in person, left at the taxpayer’s residence or dwelling, or sent by certified or registered mail (return receipt requested) to the taxpayer’s last known address.

<sup>19</sup> IRC § 6320(a)(3)(B); Treas. Reg. § 301.6320-1(b)(1).

<sup>20</sup> *Id.*

<sup>21</sup> IRC §§ 6330(a)(3)(B) and 6320(a)(3)(B); Treas. Reg. §§ 301.6320-1(c)(2) A-C1(ii) and 301.6330-1(c)(2) A-C1(ii).

<sup>22</sup> Treas. Reg. §§ 301.6320-1(i)(2) Q&A-I16 and 301.6330-1(i)(2) Q&A-I16; *Orum v. Comm’r*, 123 T.C. 1 (2004); *Moorhous v. Comm’r*, 116 T.C. 263 (2001).

<sup>23</sup> IRC §§ 6320(b)(1) and 6330(b)(1); Treas. Reg. §§ 301.6320-1(c)(2) A-C1, 301.6330-1(c)(2) A-C1, 301.6320-1(d)(2) A-D8 and 301.6330-1(d)(2) A-D8. The regulations require the IRS to provide the taxpayer an opportunity to “cure” any defect in a timely filed hearing request, including providing a reason for the hearing. Form 12153 includes space for the taxpayer to identify collection alternatives that he or she wants Appeals to consider, as well as examples of common reasons for requesting a hearing. See IRS Form 12153, *Request for Collection Due Process or Equivalent Hearing* (Mar. 2011).

<sup>24</sup> Treas. Reg. §§ 301.6320-1(i)(2) A-17 and 301.6330-1(i)(2) A-17.

<sup>25</sup> IRC § 6330(e)(1) provides the general rule for suspending collection activity. IRC § 6330(f) provides that if collection of the tax is deemed in jeopardy, the collection resulted from a levy on a state tax refund, or the IRS served a disqualified employment tax levy or a federal contractor levy, IRC § 6330 does not apply, except to provide the opportunity for a CDP hearing within a reasonable time after the levy. See *Clark v. Comm’r*, 125 T.C. 108, 110 (2005) (citing *Dora v. Comm’r*, 119 T.C. 356 (2002)).

<sup>26</sup> IRC §§ 6330(e)(1) and (e)(2).

<sup>27</sup> IRC § 6320(b)(4).

determined that a CDP hearing need not be face-to-face but can take place by telephone or by correspondence.<sup>28</sup> The Office of Appeals presumptively establishes telephonic CDP hearings, so it is incumbent on the taxpayer to request a face-to-face session.<sup>29</sup> The CDP regulations state that taxpayers who provide non-frivolous reasons for opposing the IRS collection action will generally be offered but not guaranteed face-to-face conferences.<sup>30</sup> Taxpayers making frivolous arguments are not entitled to face-to-face conferences.<sup>31</sup> A taxpayer will not be granted a face-to-face conference concerning a collection alternative, such as an IA or OIC, unless other taxpayers would be eligible for the alternative under similar circumstances.<sup>32</sup> For example, the IRS will not grant a face-to-face conference to a taxpayer who proposes an OIC as the only issue to be addressed but has failed to file all required returns and is therefore ineligible for an offer. Appeals may, however, at its discretion, grant a face-to-face conference to explain the eligibility requirements for a collection alternative.<sup>33</sup>

The CDP hearing is to be held by an impartial officer from Appeals, who is barred from engaging in *ex parte* communication with IRS employees about the substance of the case and who has had “no prior involvement” in the case.<sup>34</sup> In addition to addressing the issues raised by the taxpayer, the Appeals Officer must verify that the IRS has met the requirements of all applicable laws and administrative procedures.<sup>35</sup> In its determination, Appeals must weigh the issues raised by the taxpayer and decide whether the proposed collection

<sup>28</sup> *Katz v. Comm’r*, 115 T.C. 329, 337-38 (2000) (finding that telephone conversations between the taxpayer and the Appeals Officer constituted a hearing as provided in IRC § 6320(b)). Treas. Reg. §§ 301.6320-1(d)(2) A-D6, A-D8 and 301.6330-1(d)(2) A-D6, A-D8.

<sup>29</sup> See, e.g., Appeals Letter 4141 (rev. Oct. 2011) acknowledges the taxpayer’s request for a CDP hearing and provides information on the availability of a face-to-face conference. The National Taxpayer Advocate has repeatedly raised concerns regarding the inadequacy of Appeals’ discussion on how to request a face-to-face hearing and the location of this discussion in the letter. See National Taxpayer Advocate 2005 Annual Report to Congress, *Appeals Campus Centralization*, at 136; National Taxpayer Advocate 2009 Annual Report to Congress, *Appeals’ Efficiency Initiatives Have Not Improved Customer Satisfaction or Confidence in Appeals*, at 70, and National Taxpayer Advocate 2010 Annual Report to Congress, *The IRS’s Failure To Provide Timely and Adequate Collection Due Process Hearings May Deprive Taxpayers of an Opportunity To Have Their Cases Fully Considered*, at 128. In response to taxpayers’ and their representatives’ dissatisfaction with the Appeal’s CDP hearings, including the difficulty of receiving a face-to-face hearing, TAS worked with Appeals to test the use of “telepresence” or “virtual” face-to-face hearings. TAS began running this test in 2011 between two Low Income Taxpayer Clinics (LITCs) and two campus Appeals units.

<sup>30</sup> Treas. Reg. 301.6320-1(d)(2) A-D8.

<sup>31</sup> Treas. Reg. §§ 301.6320-1(d)(2) A-D7 and 301.6330-1(d)(2) A-D7. Appeals Letter 3846 (rev. July 2008) provides that to be allowed a face-to-face conference about collection alternatives the taxpayer must have filed all required returns.

<sup>32</sup> Treas. Reg. §§ 301.6320-1(d)(2) A-D8 and 301.6330-1(d)(2) A-D8.

<sup>33</sup> *Id.* See also National Office Program Manager Technical Advice, PMTA-2010-0153 (Mar. 23, 2010). Appeals Interim Guidance, *Face-to-Face Collection Due Process Conferences in the Absence of a Collection Information Statement* (Oct. 12, 2010), available at <http://www.irs.gov/pub/irs-utl/ap-08-1010-06.pdf>. The guidance addresses how Appeals should handle a request for a face-to-face conference when the taxpayer has not produced the collection information necessary to evaluate the collection alternative. Consistent with the regulations, the guidance states Appeals should “[g]rant a face-to-face request if it is necessary to explain the requirements for becoming eligible for a collection alternative. Taxpayers may be better able to understand the requirements for becoming eligible for a collection alternative if they are able to meet with an Appeals employee face-to-face. Examples include a taxpayer who has a hearing impairment, speaks little or no English, or lacks sophistication.” This guidance expired October 12, 2011, and is being incorporated into the Internal Revenue Manual (IRM).

<sup>34</sup> IRC §§ 6320(b)(1), 6320(b)(3), 6330(b)(1) and 6330(b)(3). See also Rev. Proc. 2000-43, 2000-2 C.B. 404. See, e.g., *Industrial Investors v. Comm’r*, T.C. Memo. 2007-93; *Moore v. Comm’r*, T.C. Memo 2006-93, *action on dec.*, 2007-2 (Feb. 27, 2007); *Cox v. Comm’r*, 514 F.3d 1119, 1124-1128 (10th Cir. 2008), *action on dec.*, 2009-22 (June 1, 2009).

<sup>35</sup> IRC § 6330(c)(1); *Hoyle v. Comm’r*, 131 T.C. 197 (2008).

action balances the need for efficient collection of taxes with the legitimate concern of the taxpayer that any collection be no more intrusive than necessary.<sup>36</sup>

Special rules apply to the IRS's handling of hearing requests that raise frivolous issues. IRC § 6330(g) provides that the IRS may disregard any portion of a hearing request based on a position the IRS has identified as frivolous, or that reflects a desire to delay or impede the administration of tax laws.<sup>37</sup> Similarly, IRC § 6330(c)(4) provides that a taxpayer cannot raise an issue at a hearing if it is based on a position identified as frivolous or reflects a desire to delay or impede tax administration.

IRC § 6702(b) allows the IRS to impose a penalty for a specified frivolous submission, which includes a frivolous CDP hearing request.<sup>38</sup> A request is subject to the penalty if any part of it "(i) is based on a position which the Secretary has identified as frivolous...or (ii) reflects a desire to delay or impede the administration of the Federal tax laws."<sup>39</sup>

#### Judicial Review of CDP Determination

Within 30 days of Appeals' determination, the taxpayer may petition the Tax Court for judicial review.<sup>40</sup> Where the validity of the underlying tax liability is properly at issue in the hearing, the court will review the amount of the tax liability on a *de novo* basis.<sup>41</sup> Where the appropriateness of the collection action is at issue, the court will review the IRS's administrative determination for abuse of discretion.<sup>42</sup>

### ANALYSIS OF LITIGATED CASES

We identified and reviewed 89 CDP court opinions, a 32 percent decrease from the 131 cases in last year's report. However, these 89 opinions do not reflect the full number of CDP cases because the court does not issue an opinion in all cases. Some are resolved through settlements, and in other cases taxpayers do not pursue litigation after filing a petition with the court. The Tax Court also disposes of some cases by issuing unpublished orders. Table 3 in Appendix III provides a detailed list of the 89 CDP opinions, including specific information about the issues, the types of taxpayers involved, and the outcomes of the cases.

<sup>36</sup> IRC § 6330(c)(3)(C).

<sup>37</sup> IRC § 6330(g). Section 6330(g) is effective for submissions made and issues raised after the date on which the IRS first prescribed a list of frivolous positions. Notice 2007-30, 2007-1 C.B. 883, which was published on or about April 2, 2007, provided the first published list of frivolous positions. Notice 2010-33, 2010-17 C.B. 609, contains the current list.

<sup>38</sup> The frivolous submission penalty applies to the following submissions: CDP hearing request, OIC, IA, and application for a taxpayer assistance order.

<sup>39</sup> IRC § 6702(b)(2)(a). Before asserting the penalty, the IRS must notify the taxpayer that it has determined that the taxpayer filed a frivolous hearing request. The taxpayer then has 30 days to withdraw the submission to avoid the penalty. IRC § 6702(b)(3).

<sup>40</sup> IRC § 6330(d)(1). Prior to October 17, 2006, the taxpayer could also petition the federal district court if the Tax Court did not have jurisdiction over the underlying tax liability (e.g., if the matter involved an employment tax liability).

<sup>41</sup> The legislative history of RRA 98 addresses the standard of review courts should apply in reviewing the Appeals' CDP determinations. H.R. Rep. No. 105-99, at 266 (Conf. Rep.). The term *de novo* means anew. Black's Law Dictionary, 447 (7th ed. 1999).

<sup>42</sup> See, e.g., *Murphy v. Comm'r*, 469 F.3d 27 (1st Cir. 2006).

### Litigation Success Rate

Taxpayers prevailed in full in three of the 89 cases (approximately three percent).<sup>43</sup> Of the cases in which the courts found for the taxpayer in whole or in part, the taxpayers appeared *pro se* in three cases<sup>44</sup> and were represented in the three others.<sup>45</sup> Table 3.3.1 below compares litigation success rates in CDP cases reported in the 2003 through 2011 Annual Reports to Congress.<sup>46</sup>

**TABLE 3.3.1, Success Rates in CDP Cases<sup>47</sup>**

| Court Decision       | 2003 | 2004 | 2005 | 2006 | 2007         | 2008 | 2009 | 2010 | 2011 |
|----------------------|------|------|------|------|--------------|------|------|------|------|
| Decided for IRS      | 96%  | 95%  | 89%  | 90%  | 92%          | 90%  | 92%  | 89%  | 92%  |
| Decided for Taxpayer | 1%   | 4%   | 8%   | 8%   | 5%           | 8%   | 4%   | 10%  | 3%   |
| Split Decision       | 3%   | 1%   | 3%   | 2%   | 3%           | 2%   | 4%   | 2%   | 3%   |
| Neither              | N/A  | N/A  | N/A  | N/A  | Less than 1% | N/A  | N/A  | N/A  | 1%   |

## ISSUES LITIGATED

The cases discussed below are those the National Taxpayer Advocate considers significant or noteworthy. The outcomes of these cases can provide important information to Congress, the IRS, and taxpayers about the rules and operation of CDP hearings. Equally important, all of the cases offer the opportunity to improve the CDP process in both application and execution.

### Procedural Rulings

#### *Dalton v. Commissioner*

In *Dalton v. Commissioner*,<sup>48</sup> the Tax Court held that the IRS abused its discretion by rejecting the taxpayers' OIC because the IRS should not have included the value of property held by a trust when evaluating the OIC. The IRS included the trust property when calculating an acceptable offer amount because it concluded that the trust was the nominee of the taxpayer.

<sup>43</sup> *Byk v. Comm'r*, T.C. Summ. Op. 2010-137, *Dalton v. Comm'r*, 135 T.C. 393 (2010), *appeal docketed* (1st Cir. Oct. 12, 2011), and *Alessio Azzari, Inc. v. Comm'r*, 136 T.C. 178 (2011).

<sup>44</sup> *Byk v. Comm'r*, T.C. Summ. Op. 2010-137 *Malone v. Comm'r*, T.C. Summ. Op. 2011-24 and *Thornberry v. Comm'r*, 136 T.C. 356 (2011).

<sup>45</sup> *Dalton v. Comm'r*, 135 T.C. 393 (2010), *appeal docketed* (1st Cir. Oct. 12, 2011), *Orian v. Comm'r*, T.C. Memo. 2010-234, and *Alessio Azzari, Inc. v. Comm'r*, 136 T.C. 178 (2011).

<sup>46</sup> See National Taxpayer Advocate 2008 Annual Report to Congress 482, Table 3.2.1, for 2003, 2004, 2005, 2006, 2007, 2008, 2009, 2010, and 2011 statistics.

<sup>47</sup> Numbers have been rounded to nearest percentage. A "split" decision refers to a case with multiple issues where both the IRS and the taxpayer prevail on one or more substantive issues. A "neither" decision refers to a case where the court's decision was not in favor of either party.

<sup>48</sup> 135 T.C. 393 (2010), *appeal docketed* (1st Cir. Oct. 12, 2011).

As a threshold matter, the Tax Court had to determine whether it had jurisdiction to enter a decision that would affect a trust when the trust was not a party to the proceeding. The court found that although it could not enter a decision affecting the trust, it had jurisdiction to determine whether the IRS abused its discretion by rejecting the OIC, and that in exercising that jurisdiction it was proper for the court to examine whether the trust held property as the nominee of the taxpayers. After examining all the facts and analyzing the relevant law, the court found that the trust did not hold the property as a nominee for the taxpayer. The court reached this conclusion in part because the trust was validly created under Maine law, and all of the transfers of property were recorded more than ten years before the tax liability at issue arose.

#### *Tucker v. Commissioner*

In July 2005, Mr. Tucker submitted an OIC in which he agreed to pay a total of \$36,772 (\$317 per month for 116 months) to settle his tax debts for 2000, 2001, and 2002.<sup>49</sup> The Settlement Officer rejected the offer, concluding that the taxpayer's dissipated assets had to be considered when determining the proper offer amount. A dissipated asset is any asset "that has been sold, transferred, or spent on non-priority items or debts and that is no longer available to pay the tax liability."<sup>50</sup> If the IRS determines an asset is dissipated, the IRS can include its value when determining the proper offer amount.<sup>51</sup>

In January 2003, Mr. Tucker opened an E-trade account and began day trading. During that month, he deposited \$23,700 into the account and deposited \$21,000 more between March 13 and April 3. Mr. Tucker had not yet filed his tax returns for tax years 1999 through 2001, although the returns were past due. As a result, in April of 2003 he had accrued tax liabilities of approximately \$14,945 for those years. Mr. Tucker stated that he made the deposits and engaged in the trading in an effort to make enough money to pay off his delinquent taxes, as well as paying his upcoming 2002 tax liability.

By the time Mr. Tucker stopped trading on April 21, 2003, he had lost \$22,645 of his initial \$44,700 deposits, which left approximately \$22,000 in the E-Trade account. Mr. Tucker maintained that he used this money to provide for basic living expenses from May 2 through October 27, 2003. Because the court must evaluate the facts in the light most favorable to the taxpayer when evaluating the IRS's motion for summary judgment, the court found the taxpayer used the \$22,000 for necessary expenses. Therefore, the court looked at only the other \$22,645 that Mr. Tucker lost as potential dissipated assets.

The court held that the Office of Appeals acted appropriately in finding that assets were dissipated; Mr. Tucker knew he had tax liabilities for tax years 1999, 2000, and 2001, and had the cash to pay them in full as of early 2003, but chose instead to hold that money in

<sup>49</sup> T.C. Memo. 2011-67, *appeal docketed*, No. 11-1191 (D.C. Cir. May 23, 2011).

<sup>50</sup> *Tucker v. Comm'r*, T.C. Memo. 2011-67, *appeal docketed*, No. 11-1191 (D.C. Cir. May 23, 2011).

<sup>51</sup> IRM 5.8.5.16 (Oct. 22, 2010).

a risky investment. However, the Tax Court found that only \$14,975 should be considered a dissipated asset because in April 2003, when Mr. Tucker had lost \$22,645 from his day trading, he only had outstanding federal tax liabilities of \$14,975.

*Alessio Azzari, Inc. v. Commissioner*

In *Alessio Azzari, Inc. v. Commissioner*,<sup>52</sup> the taxpayer requested subordination of the NFTL. The taxpayer entered into a financing agreement with Penn Business Credit (PBC) in which PBC agreed to make loans that would be secured by the taxpayer's accounts receivable. When PBC discovered the NFTL filing, it refused to make any more loans until the NFTL had been subordinated to PBC's security interest in the accounts receivable. The Settlement Officer determined that subordination was not an option because the IRS did not have priority over PBC. The Appeals Officer simply compared the date the PBC financing statement was filed to the date the NFTL was filed. Because PBC filed its statement first, on February 2, 2007, and the IRS did not file the NFTL until November 26, 2007, the Appeals Officer determined PBC already had priority and the NFTL could not be subordinated. However, the Court ruled this determination was an error of law.

The court found under IRC § 6323(c) that the accounts receivable on the taxpayer's books before the filing of the NFTL were complete and superior to subsequent liens because the amounts were then fixed and ascertainable.<sup>53</sup> However, to the extent that accounts receivable were acquired more than 45 days after the NFTL was filed or after PBC had actual knowledge of the NFTL, whichever was earlier, the government's tax lien had priority. Accordingly, the court held it was an abuse of discretion for the Settlement Officer to fail to consider the taxpayer's request to subordinate the lien on the basis of an erroneous conclusion of law that the federal tax lien did not have priority.

The court further held that it was an abuse of the Appeals Officer's discretion to reject the taxpayer's proposed IA, because the taxpayer's failure to timely make employment tax deposits for the third quarter of 2008, making him noncompliant, was not independent of the Appeals Officer's erroneous determination that the NFTL could not be subordinated. The taxpayer contended it could have made the deposits on time if the subordination was granted, and could have borrowed against its accounts receivable in June or even earlier. Therefore, unlike other cases where the courts have ruled it was not an abuse of discretion to reject an IA due to noncompliance, the noncompliance here was driven by the Appeals Officer's erroneous determination and not by the taxpayer alone. The court remanded the case so Appeals could reconsider the taxpayer's request to subordinate the NFTL and enter into an IA.

<sup>52</sup> 136 T.C. 178 (2011).

<sup>53</sup> The basic rule for determining priority of competing liens is referred to as "first in time, first in right." IRC § 6323(c) modifies the result by providing that if an account receivable is acquired more than 45 days after the NFTL is filed, the lender's security interest in the account receivable will not have priority over the tax lien even if the agreement establishing the security interest predates the NFTL filing. See *Am. Inv. Fin. v. United States*, 476 F.3d 810 (10th Cir. 2006).

***Thornberry v. Commissioner***

In *Thornberry v. Commissioner*,<sup>54</sup> the IRS sent the taxpayers CDP notices under IRC §§ 6320 and 6330 with respect to the taxpayers' unpaid income taxes for 2000, 2001, and 2002, and a civil penalty under IRC § 6702. The taxpayers' timely request for a hearing included frivolous arguments, but also legitimate ones such as requesting an IA and the discharge, withdrawal, or subordination of the NFTL. In response, the Settlement Officer sent a boilerplate Letter 4380, *Appeals Received Your Request for a Collection Due Process and/or Equivalent Hearing*. It stated that the officer had determined the request for a hearing contained either a frivolous position specifically identified by the IRS in Notice 2008-14,<sup>55</sup> a frivolous reason not specified in the notice, or constitutional, moral, or religious arguments. However, the Settlement Officer did not specify what arguments raised frivolous issues. The Settlement Officer requested that the taxpayers either amend the request to reflect only legitimate issues or withdraw the entire request. The Settlement Officer warned that failure to take such action within 30 days would result in the case being returned to the Collection function and a frivolous submission penalty of \$5,000 under IRC § 6702(b) being assessed. The Settlement Officer also explained that if Appeals disregarded the hearing request, the taxpayers could not seek review of that decision by the Tax Court. The taxpayers took no action, the Settlement Officer sent the case back to Collection, and the taxpayers then petitioned the Tax Court for judicial review of the Settlement Officer's decision.

The IRS filed a motion to dismiss for lack of jurisdiction because Appeals had made no determination that would confer jurisdiction on the court. However, the Tax Court held that if Appeals determines a request for an administrative hearing is based entirely on a frivolous position under IRC § 6702(c), and issues a notice stating that Appeals will disregard the request, the Tax Court does have jurisdiction to review Appeals' decision if the taxpayer timely petitions for review. The Tax Court found the Appeals letter disregarding the hearing request was a determination conferring jurisdiction under IRC § 6330(d)(1) because it authorized the IRS to proceed with the disputed collection action.

After determining that it did have jurisdiction, the court ordered the taxpayers to file a report setting forth the specific issues they wanted to raise at their hearing. The taxpayers stated they wished to contest the assessment of the civil penalty and discuss collection alternatives and that the taxpayer-wife wanted to seek innocent spouse relief. The court then remanded the case back to Appeals to consider these issues.<sup>56</sup>

***Brady v. Commissioner***

In *Brady v. Commissioner*,<sup>57</sup> the taxpayer argued at his CDP hearing that he was entitled to overpayments from prior years that would satisfy his liability if applied to it. The Appeals

<sup>54</sup> 136 T.C. 356 (2011).

<sup>55</sup> 2008-1 C.B. 310.

<sup>56</sup> *Thornberry v. Comm'r*, T. C. Docket No. 580-10L (Aug. 3, 2011).

<sup>57</sup> 136 T.C. No. 19 (2011), *appeal docketed* (2nd Cir. July 13, 2011).

Officer rejected the taxpayer's position because the IRS had already disallowed his refund claims and sent him a notice of disallowance by certified mail in 2004 or 2005 (the date was in dispute). Under IRC § 6532, the taxpayer had two years from the date of the disallowance to file a refund suit. However, the taxpayer missed the two-year limitation regardless of whether the notice was issued in 2004 or 2005. Because the taxpayer did not file within that time, any suit or judicial proceeding challenging the disallowance of the refund claims was barred. The taxpayer was also barred from receiving any credit toward his liability under IRC § 6514(a), which prohibits credits or refunds from being applied or issued when the statute of limitations for claim for refund has expired.

### Appeals Officer's Legal Authority

#### *Tucker v. Commissioner*

In *Tucker v. Commissioner*,<sup>58</sup> the court considered Mr. Tucker's motion for remand, which contested the constitutional validity of the Office of Appeals' staffing. Mr. Tucker argued that an Appeals Officer is an "Officer of the United States" who must be appointed by the President or by one of "the Heads of Departments" (in this case, the Secretary of the Treasury), according to the Appointments Clause of Article II, Section 2, of the Constitution.<sup>59</sup> However, the Appeals Officers who conducted Mr. Tucker's CDP hearings and the team manager who signed and issued the notices of determination were not appointed, but hired by the IRS Commissioner under IRC § 7804(a). Therefore, Mr. Tucker argued he had not been given the CDP hearing that Congress mandated.

To be considered an "Officer of the United States" for purposes of the Appointments Clause, it is characteristic for the position to be "established by Law" or carry "significant authority." In this case, the court held that the positions of Settlement Officer, Appeals Officer, and team manager are not "established by law" and do not have "significant authority." The court explained that the Appeals Officer does not exercise an authority more "significant" than the authority exercised by other personnel important to tax administration, such as the Chief of the Office of Appeals (an Appeals Officer's superior), or other high-ranking officials in the IRS, or as significant as the authority exercised by Administrative Law Judges in many other agencies. Because none of these IRS positions involve significant authority, the court determined that singling out IRS Appeals Officers as somehow possessing that authority and requiring constitutional appointment would be inappropriate.

#### *Byk v. Commissioner*

Although the following case has no precedential value because it is a small tax case, we have included it to highlight the importance of verifying, as required under the Code, that all applicable law and administrative procedures have been met. In *Byk v. Commissioner*,<sup>60</sup>

<sup>58</sup> *Tucker v. Comm'r*, 135 T.C. 114 (2010), appeal docketed, No. 11-1191 (D.C. Cir. May 23, 2011).

<sup>59</sup> U.S. Const., art. II, sec. 2, cl. 2.

<sup>60</sup> *Byk v. Comm'r*, T.C. Summ. Op. 2010-137.

the IRS in 2007 sent the taxpayer a NFTL concerning his Form 941, *Employee's Quarterly Federal Tax Return*, liability for the second quarter of 2000, and the taxpayer filed a timely hearing request. At the hearing, the taxpayer asserted that he had timely filed his Form 941 and paid the tax. Appeals disagreed and issued a determination sustaining the lien and stating that it had verified that the IRS had followed all legal and procedural requirements. The taxpayer filed a petition in the Tax Court seeking review of the determination on the grounds that the Appeals Officer had failed to verify that IRS actions and procedures were in accordance with the law, and maintaining that a return had been filed and the liability paid.

The court found Appeals failed to establish that it had verified that all legal and procedural requirements were met, which is required under IRC § 6330(c)(1). The IRS witness testified that the IRS normally provides taxpayers with a transcript documenting nonfiling of a return or a Form 3050, *Certification of Lack of Record*, supporting the IRS determination that a return had not been filed. In this case, however, the IRS provided no such documentation. The IRS only provided the taxpayer with transcripts that were hard to read, and with two codes to decipher the numerous symbols, codes, and acronyms in the transcripts—many of which the IRS witness could not explain. The IRS simply asserted the taxpayer's Form 941 for that tax period was not filed until 2008 but offered no supporting evidence; nor could the IRS witness verify it. Thus, the court concluded Appeals had not adequately shown that the Appeals Officer had verified that all requirements were met, and that Appeals' determination to proceed with collection without verification was an error as a matter of law.

### Imposition of Sanctions

Over the past few years, one notable issue that began emerging from the review of CDP decisions was the extent to which the courts imposed sanctions on taxpayers for frivolous positions. IRC § 6673(a)(1) authorizes the Tax Court to impose sanctions when it appears that proceedings have been instituted or maintained primarily for delay or when the taxpayer's position is frivolous or groundless.<sup>61</sup> These penalties are meant to deter the filing of frivolous CDP hearing requests. As we found in last year's analysis, the courts imposed these penalties in only a few cases. Of the 89 cases decided during this year's review period, the courts imposed sanctions in only four cases, or approximately four percent.<sup>62</sup> Last year, with 131 cases decided, the courts imposed sanctions in five cases, which again was four percent.<sup>63</sup> This low number may be attributable to IRC § 6330(g),<sup>64</sup> which allows the IRS to disregard a frivolous hearing request.

<sup>61</sup> For a more detailed discussion of IRC § 6673, see Most Litigated Issue: *Frivolous Issues Penalty and Related Appellate Level Sanctions Under Internal Revenue Code Section 6673*, *infra*.

<sup>62</sup> See, e.g., *Mattina v. Comm'r*, T.C. Memo. 2010-127, *appeal docketed*, No. 10-73032 (9th Cir. Sept. 27, 2010); *Miller-Wagenknecht v. Comm'r*, 385 Fed. Appx. 230 (3d Cir. 2010).

<sup>63</sup> National Taxpayer Advocate 2010 Annual Report to Congress at 437.

<sup>64</sup> Pub. L. No. 109-432, 120 Stat. 2922 (2006).

### Pro Se Analysis

*Pro se* taxpayers (those without benefit of counsel) litigated 56 (or 63 percent) of the 89 CDP cases brought before the Tax Court, a small decrease from 64 percent in the previous year, but still up from 58 percent in 2008.<sup>65</sup> Table 3.3.2 shows the breakdown of *pro se* and represented cases and the decisions rendered by the court, indicating that about seven percent of taxpayers (represented or unrepresented) received some relief on judicial review.

**TABLE 3.3.2, Pro Se and Represented Taxpayer Cases and Decisions**

| Court Decisions      | Pro Se Taxpayers |                     | Represented Taxpayers |                     |
|----------------------|------------------|---------------------|-----------------------|---------------------|
|                      | Volume           | Percentage of Total | Volume                | Percentage of Total |
| Decided for IRS      | 53               | 95%                 | 29                    | 88%                 |
| Decided for Taxpayer | 1                | 2%                  | 2                     | 6%                  |
| Split Decisions      | 2                | 4%                  | 1                     | 3%                  |
| Neither              |                  |                     | 1                     | 3%                  |
| <b>Totals</b>        | <b>56</b>        |                     | <b>33</b>             |                     |

### CONCLUSION

CDP hearings continue to provide an invaluable opportunity for taxpayers to meaningfully address the appropriateness of IRS collection actions. Given the important protection that CDP hearings offer, it should be of little surprise that CDP remains one of the most frequently litigated tax issues in the federal courts—a trend unlikely to change anytime soon. The cases this year illustrate how complex issues involving both collection and collection alternatives are often present in CDP cases, and that Appeals Officers must have extensive knowledge of these areas to handle the cases properly. The Tax Court also grappled with the scope of its authority to review IRS decisions disregarding a frivolous hearing request under IRC § 6330(g) and to consider issues that may affect third parties that have not been joined in the proceeding. Because of the important role of CDP hearings in protecting taxpayer rights, taxpayers and their representatives will likely continue to pursue their CDP rights in court, and CDP will most likely continue to be a heavily litigated issue in years to come.

<sup>65</sup> National Taxpayer Advocate 2008 Annual Report to Congress 486.

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#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

### SUMMARY

We reviewed 74 decisions issued by the federal court system from June 1, 2010, to May 31, 2011, regarding the addition to tax under Internal Revenue Code (IRC) § 6651(a)(1) for failure to timely file a tax return, the addition to tax under IRC § 6654 for failure to pay estimated income tax, or both.<sup>1</sup> The phrase “addition to tax” is commonly referred to as a penalty, so we will refer to these two additions to tax as the failure to file penalty and the estimated tax penalty. Thirty-two cases involved the 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 failure to file penalty is mandatory unless the taxpayer can demonstrate that the failure is due to reasonable cause and not willful neglect.<sup>2</sup> The estimated tax penalty is mandatory unless the taxpayer can meet one of the statutory exceptions.<sup>3</sup> In the cases analyzed, taxpayers were largely unable to avoid either penalty.

### PRESENT LAW

Under IRC § 6651(a)(1), a taxpayer that fails to file a return on or before its due date (including extensions) will be subject to a five percent penalty for each month or partial month the return is late, up to a maximum of 25 percent, unless the failure is due to reasonable cause and not willful neglect.<sup>4</sup> The penalty is based on the amount of tax due, minus any credit the taxpayer is entitled to receive or payment made by the due date.<sup>5</sup> The failure to file penalty applies to income, estate, gift, and certain excise tax returns.<sup>6</sup> To establish reasonable cause, the taxpayer must show that he or she exercised ordinary business care and prudence but was still unable to file by the due date.<sup>7</sup>

IRC § 6654 imposes a penalty on any underpayment of a required installment of estimated tax by an individual.<sup>8</sup> The law requires four installments per taxable year, each of which is generally 25 percent of the annual payment.<sup>9</sup> The required annual payment is the lesser

<sup>1</sup> IRC §§ 6651(a)(2) and (a)(3) also impose additions to tax for failure to pay a tax liability shown on a return and for failure to pay a required tax liability not shown on a return, respectively. However, because only a small number of cases involved these penalties, we did not include them in our analysis.

<sup>2</sup> IRC § 6651(a)(1).

<sup>3</sup> IRC § 6654(e).

<sup>4</sup> IRC § 6651(a)(1). The penalty is increased to 15 percent per month up to a maximum of 75 percent if the failure to file is fraudulent. See IRC § 6651(f).

<sup>5</sup> IRC § 6651(b)(1).

<sup>6</sup> IRC § 6651(a)(1).

<sup>7</sup> Treas. Reg. § 301.6651-1(c)(1).

<sup>8</sup> IRC §§ 6654(a), (b).

<sup>9</sup> IRC §§ 6654(c)(1), (d)(1).

of 90 percent of the tax for the current taxable year or 100 percent of the tax shown on the taxpayer's return for the previous year.<sup>10</sup> The IRS will determine the amount of the penalty by applying the underpayment rate according to IRC § 6621 to the amount of the underpayment for the related period.<sup>11</sup>

The estimated tax penalty applies to returns of individuals and certain estates and trusts.<sup>12</sup> To avoid the penalty, the taxpayer has the burden of proving that one of the following exceptions applies:

- The tax due (after taking into account any federal income tax withheld) is less than \$1,000;<sup>13</sup>
- The preceding taxable year was a full 12 months, the taxpayer had no liability for the preceding taxable year, and the taxpayer was a U.S. citizen or resident throughout the preceding taxable year;<sup>14</sup>
- The IRS determines that because of casualty, disaster, or other unusual circumstances, the imposition of the penalty would be against equity and good conscience;<sup>15</sup> or
- The taxpayer retired after reaching age 62 or became disabled in the taxable year for which estimated payments were required or in the taxable year preceding that year, and the underpayment was due to reasonable cause and not willful neglect.<sup>16</sup>

In any court proceeding, the IRS has the initial burden of providing sufficient evidence that it appropriately imposed the failure to file penalty and the estimated tax penalty.<sup>17</sup>

## ANALYSIS OF LITIGATED CASES

We analyzed 74 opinions issued between June 1, 2010, and May 31, 2011, where the failure to file penalty or estimated tax penalty (or both) was in dispute. All but three of these cases were litigated in the United States Tax Court. A detailed list appears in Table 4 in Appendix III. Forty-nine cases involved individual taxpayers and 25 involved businesses (including individuals engaged in self-employment or partnerships). Of the 65 cases in which taxpayers appeared *pro se* (without counsel), taxpayers prevailed in full in only one case, and three cases resulted in split decisions. Of the nine cases in which taxpayers appeared with representation, two were resolved in the taxpayer's favor.

<sup>10</sup> IRC §§ 6654(d)(1)(B)(i), (ii).

<sup>11</sup> IRC §§ 6654(a)(1) – (3).

<sup>12</sup> IRC §§ 6654(a), (l).

<sup>13</sup> IRC § 6544(e)(1).

<sup>14</sup> IRC § 6654(e)(2).

<sup>15</sup> IRC § 6654(e)(3)(A).

<sup>16</sup> IRC § 6654(e)(3)(B).

<sup>17</sup> *Higbee v. Comm'r*, 116 T.C. 438, 446 (2001) (quoting IRC § 7491(c)). An exception to this rule alleviates the IRS from this initial burden where the taxpayer's petition fails to state a claim for relief from the penalty, such as where the taxpayer only makes frivolous arguments. *Funk v. Comm'r*, 123 T.C. 213 (2004).

### Failure to File Penalty

A common basis for the courts' ruling against taxpayers was the lack of evidence that the failure to file was due to reasonable cause. In fact, in 56 of the 72 cases, the taxpayers did not present any evidence of reasonable cause. In cases where taxpayers did present evidence in defense of their failures to file timely (or at all), the arguments included the following:

**Medical Illness:** Depending on the facts and circumstances, a medical illness may establish reasonable cause for failing to file, if the taxpayer can show incapacitation to such a degree that he or she could not file a return on time.<sup>18</sup> A court also may find reasonable cause where a taxpayer who is caring for another person is unable to file on time due to providing the care.<sup>19</sup>

The Tax Court determined that reasonable cause did not exist where a taxpayer claimed that her health complications and medical issues prevented her from filing a return, because during the same period she was able to travel and earn significant income as a real estate agent.<sup>20</sup> The same rationale applied in *Campbell v. Commissioner*, in which the taxpayers (husband and wife) argued that their need to care for a sick daughter who was going through pregnancy provided them with reasonable cause for filing their return two years late.<sup>21</sup> The Tax Court held that because they also ran a construction business and operated a distributorship to sell products through direct marketing, despite their daughter's illness, it was implausible that caring for her constituted reasonable cause for failing to timely file.<sup>22</sup>

**Mistaken Belief as to Filing Obligation:** Taxpayers often mistakenly believe they are not required to file returns. If a taxpayer's mistaken belief about the filing requirement is based on an incomplete or flawed reading of the law, the taxpayer does not have reasonable cause.<sup>23</sup> When a taxpayer receives competent advice that leads him or her to believe there is no filing requirement, courts may be more inclined to conclude that the failure to file is reasonable. For example, in *Holmes v. Commissioner*, the taxpayer prevailed on an argument that he was not required to file because he understood that the wages he received while working in a combat zone in Iraq were not taxable.<sup>24</sup> This belief was based on a memo promulgated by the IRS. The Tax Court held that the

<sup>18</sup> *Williams v. Comm'r*, 16 T.C. 893, 905-06 (1951) (interpreting § 291 of the 1939 Code, a predecessor to IRC § 6651), acq., 1951-2 C.B. 1. See, e.g., *Harbour v. Comm'r*, T.C. Memo. 1991-532 (the taxpayer was in a coma the month before the due date of his tax return and therefore had reasonable cause for failing to timely file).

<sup>19</sup> *Tabbi v. Comm'r*, T.C. Memo. 1995-463 (reasonable cause existed for late filing a joint return when taxpayers' son had heart surgery and taxpayers were continuously at hospital for four months surrounding due date of return).

<sup>20</sup> *Coury v. Comm'r*, T.C. Memo. 2010-132.

<sup>21</sup> T.C. Memo. 2011-42.

<sup>22</sup> *Campbell v. Comm'r*, T.C. Memo. 2011-42.

<sup>23</sup> See *Shomaker v. Comm'r*, 38 T.C. 192, 202 (1962) (citation omitted) ("in the absence of obtaining competent advice, the mistaken belief on the part of a taxpayer that no return was required under the statute does not constitute reasonable cause for noncompliance.").

<sup>24</sup> T.C. Memo. 2011-26.

taxpayer's mistaken belief that his payments were not taxable was reasonable, given his lack of background in tax law, coupled with the fact the advice came directly from the IRS while he was serving in a combat zone. Consequently, the taxpayer was not liable for the failure to file penalty.<sup>25</sup>

**Reliance on Agent:** The United States Supreme Court, in *United States v. Boyle*,<sup>26</sup> held that taxpayers have a nondelegable duty to file a return on time, and a taxpayer's reliance on an agent does not excuse a failure to file. In *Owusu v. Commissioner*, a taxpayer who failed to timely file his return argued that he instructed his accountant to request an extension because he needed to correct his Form W-2, *Wage and Tax Statement*, and he filed the return as soon as possible when he learned the extension had not been requested.<sup>27</sup> Citing *Boyle*, the Tax Court held that even if the taxpayer believed his accountant had filed the extension request, reliance on his accountant did not constitute reasonable cause, and therefore the taxpayer was liable for the penalty.<sup>28</sup>

A taxpayer may establish reasonable cause if the taxpayer can prove that he or she reasonably relied on a professional tax advisor or that the taxpayer made a good-faith effort to ascertain return filing requirements.<sup>29</sup> In order to reasonably rely on the advice of a tax professional, the taxpayer must present evidence of the professional's expertise and show that the taxpayer provided him or her with all necessary and accurate information.<sup>30</sup> In *Russell v. Commissioner*, the taxpayer argued that she filed her return late because her attorney advised her to delay filing until the exact losses from her husband's business could be calculated and used to offset the couple's income. The taxpayer alleged that her attorney advised her that filing a return without perfect information would be fraudulent and perjurious.<sup>31</sup> The Tax Court concluded that the taxpayer had an obligation to file a timely return with the best available information, and amend it later.<sup>32</sup> Consequently, reliance on her attorney's advice that it was necessary to wait for complete information before filing a return was not reasonable cause.<sup>33</sup>

**"Zero Return" Filers and Other Frivolous Arguments:** Under the longstanding four-part test articulated in *Beard v. Commissioner*, a valid return must: (1) purport to be a return; (2) be signed under penalties of perjury; (3) contain sufficient data to calculate the tax liability; and (4) represent an honest and reasonable attempt to satisfy

<sup>25</sup> *Holmes v. Comm'r*, T.C. Memo. 2011-26.

<sup>26</sup> 469 U.S. 241 (1985).

<sup>27</sup> T.C. Memo. 2010-186.

<sup>28</sup> *Owusu v. Comm'r*, T.C. Memo. 2010-186.

<sup>29</sup> *Estate of La Meres v. Comm'r*, 98 T.C. 294, 315-17 (1992) (citations omitted).

<sup>30</sup> *Id.*

<sup>31</sup> T.C. Memo. 2011-81.

<sup>32</sup> *Russell v. Comm'r*, T.C. Memo. 2011-81 (citing *Estate of Vriniotis v. Comm'r*, 79 T.C. 298, 311 (1982)).

<sup>33</sup> *Russell v. Comm'r*, T.C. Memo. 2011-81.

the requirements of the tax laws.<sup>34</sup> Each year, some taxpayers claim they have no obligation to pay taxes by filing returns reporting zero income when they have earned substantial wages accurately reported on a Form W-2.<sup>35</sup> A “zero return” does not constitute a tax return under the *Beard* test for purposes of the failure to file penalty of IRC § 6651(a)(1).<sup>36</sup> Thus, when the taxpayer in *Oman v. Commissioner* filed a return containing all zeros, the Tax Court sustained the IRS’s decision to impose the failure to file penalty.<sup>37</sup>

In addition, any departure from the jurat<sup>38</sup> above the signature block provided in IRS forms invalidates a document purporting to be a return under the *Beard* test.<sup>39</sup> For example, in *Holmes v. Commissioner*,<sup>40</sup> the taxpayer wrote “Non assumpsit by” over his signature on the jurat of his return and stated that for reasons of conscience he would not swear an oath for his tax return, among other arguments. The court rejected his arguments and upheld the failure to file penalty. In addition, the court applied the IRC § 6673 penalty for making frivolous arguments.<sup>41</sup> In nine other cases where the IRS had asserted the failure to file penalty, the courts also imposed the IRC § 6673 penalty when the taxpayers presented frivolous arguments.<sup>42</sup>

### Estimated Tax Penalty

Courts routinely found taxpayers liable for the IRC § 6654 estimated tax penalty when the IRS proved the taxpayer had a tax liability, had no withholding credits, made no estimated tax payments for that year, and the taxpayer offered no evidence to refute the IRS’s evidence.<sup>43</sup>

The IRS has the burden of production under IRC § 7491(c) to produce evidence that a taxpayer was required to make an annual payment under IRC § 6654(d)(1)(B). In both cases where the taxpayers prevailed regarding the estimated tax penalty for some or all of the years at issue, their success was a result of the IRS failing to prove the penalty was appropriate. For example, in *Banister v. Commissioner*, the U.S. Court of Appeals for the Ninth Circuit upheld the Tax Court’s determination that the IRS had not met its burden of

<sup>34</sup> 82 T.C. 766, 777 (1984), *aff’d per curiam*, 793 F.2d 139 (6th Cir. 1986).

<sup>35</sup> See, e.g., *Burchfield v. Comm’r*, T.C. Memo. 2011-30 (taxpayer and spouse earned over \$100,000 in wages but reported zero wage income on Form 1040).

<sup>36</sup> See *Turner v. Comm’r*, T.C. Memo. 2004-251, and the numerous cases cited therein.

<sup>37</sup> T.C. Memo. 2010-276.

<sup>38</sup> A “jurat” is a “certification added to an affidavit or deposition stating when and before what authority the affidavit or deposition was made.” *Black’s Law Dictionary* (9th ed. 2009).

<sup>39</sup> See *Borgeson v. United States*, 757 F.2d 1071 (10th Cir. 1985).

<sup>40</sup> T.C. Memo. 2011-31.

<sup>41</sup> IRC § 6673 authorizes the United States Tax Court to impose a penalty against a taxpayer if the taxpayer institutes or maintains a proceeding primarily for delay, takes a frivolous position in a proceeding, or unreasonably fails to pursue available administrative remedies.

<sup>42</sup> See Most Litigated Issue: *Frivolous Issues Penalty Under Internal Revenue Code Section 6673 and Related Appellate-Level Sanctions, infra*.

<sup>43</sup> See, e.g., *Amesbury v. Comm’r*, T.C. Memo. 2010-148; *Steinshouer v. Comm’r*, T.C. Memo. 2011-53.

production because it introduced no evidence that the taxpayer filed a return for the previous tax year.<sup>44</sup>

## CONCLUSION

The United States tax system relies on taxpayers voluntarily filing accurate returns and paying their taxes. Penalties attempt to establish fairness by imposing an additional cost on the noncompliant taxpayer. The penalties for failure to file and failure to pay estimated tax were designed to encourage voluntary compliance and deter noncompliance.<sup>45</sup>

The IRS should determine whether these penalties positively influence compliance as intended, particularly in the case of taxpayers who comply with their filing obligations, although in an untimely manner. If compliance is not significantly improved, then the penalties fail to serve their primary function. Although revenue is generated by the penalties, the imposition of a one-time abatement for taxpayers who comply with filing obligations in an untimely manner could potentially reduce litigation without significantly impacting compliance. The National Taxpayer Advocate reiterates her recommendation to implement a one-time abatement of the failure to file penalty for taxpayers who comply with their filing obligations, but in an untimely manner.<sup>46</sup>

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<sup>44</sup> 107 A.F.T.R.2d (RIA) 1156 (9th Cir. 2011), *aff'g* T.C. Memo. 2008-201.

<sup>45</sup> See Policy Statement 20-1 (formerly P-1-18), IRM 1.2.20.1.1 (June 29, 2004). See also *United States v. Boyle*, 469 U.S. 241, 245 (1985) (“Congress’ purpose in the prescribed civil penalty was to ensure timely filing of tax returns to the end that tax liability will be ascertained and paid promptly.”).

<sup>46</sup> See National Taxpayer Advocate 2001 Annual Report to Congress 188. A provision to waive the failure to file penalty for first-time unintentional minor errors was included in the House-passed Taxpayer Protection and IRS Accountability Act of 2003. See H.R. 1528, 108th Cong. § 106 (2003). Although the IRS has provided for a one-time administrative waiver of the failure to file penalty in IRM 20.1.1.3.6.1 (Dec. 11, 2009), the National Taxpayer Advocate continues to recommend a statutory waiver similar to IRC § 6656(c).

MLI  
#5**Gross Income Under Internal Revenue Code Section 61 and Related Sections****SUMMARY**

When preparing tax returns, taxpayers must complete the crucial calculation of gross income for the taxable year to determine the tax they must pay. Gross income has been among the Most Litigated Issues in each of the National Taxpayer Advocate's Annual Reports to Congress.<sup>1</sup> For this report, we reviewed 62 cases decided between June 1, 2010, and May 31, 2011. Gross income issues in these cases include:

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

**PRESENT LAW**

Internal Revenue Code (IRC) § 61 broadly defines gross income as “all income from whatever source derived.”<sup>2</sup> The U.S. Supreme Court has defined gross income as any accession to wealth.<sup>3</sup> However, over time, Congress has carved out numerous exceptions to and exclusions from this broad definition and has based other elements of tax law on the definition.<sup>4</sup>

**ANALYSIS OF LITIGATED CASES**

In the 62 opinions involving gross income issued by the federal courts and reviewed for this report, gross income issues 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. A detailed list of all cases analyzed appears in Table 5 of Appendix III.

In 16 cases (about 26 percent), taxpayers were represented, while the rest were *pro se* (without counsel). Three of the 16 represented taxpayers (about 19 percent) prevailed in full in their cases, whereas *pro se* taxpayers prevailed in full in just one case, and in part in five others. Overall, taxpayers prevailed in full or in part in nine of 62 cases (less than 15 percent). The vast majority of gross income cases this year involved taxpayers failing to

<sup>1</sup> See, e.g., National Taxpayer Advocate 2009 Annual Report to Congress 445-450; National Taxpayer Advocate 2010 Annual Report to Congress 467-471.

<sup>2</sup> IRC § 61(a).

<sup>3</sup> *Comm'r v. Glenshaw Glass*, 348 U.S. 426, 431 (1955) (interpreting § 22 of the Internal Revenue Code of 1939, the predecessor to IRC § 61).

<sup>4</sup> See, e.g., IRC §§ 104 (compensation for injuries or sickness); 105 (amounts received under accident and health plans); 108 (income from discharge of indebtedness); 6501 (limits on assessment and collection, determination of “substantial omission” from gross income).

report items of income, including some specifically mentioned in IRC § 61 such as wages,<sup>5</sup> interest,<sup>6</sup> and pensions.<sup>7</sup>

Concerning items that can be excluded from gross income, the following are some of the issues litigated.

### Damage Awards

Taxation of damage awards continues to generate litigation. This year, at least seven taxpayers (about 11 percent of the cases reviewed) challenged the inclusion of damage awards in their gross income, and only one taxpayer prevailed in part on the issue.<sup>8</sup> IRC § 104(a)(2) specifies that damage awards and settlement proceeds<sup>9</sup> are taxable as gross income unless the award was received “on account of personal physical injury or physical sickness.”<sup>10</sup> Congress added the “physical injury or physical sickness” requirement in 1996;<sup>11</sup> until then, the word “physical” did not appear in the statute. The legislative history of the 1996 amendments to IRC § 104(a)(2) provides that “[i]f an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness... [but] emotional distress is not considered a physical injury or physical sickness.”<sup>12</sup> Thus, damage awards for emotional distress are not considered as received on account of physical injury or physical sickness, even if the injury is emotional distress resulting in “insomnia, headaches, [or] stomach disorders.”<sup>13</sup>

To justify exclusion from income under IRC § 104, the taxpayer must show settlement proceeds are in lieu of damages for physical injury or sickness.<sup>14</sup> In *Parkinson v. Commissioner*, the taxpayer petitioned the U.S. Tax Court to exclude from his income a settlement award from an intentional infliction of emotional distress and invasion of privacy lawsuit.<sup>15</sup> During the course of his employment, he suffered a heart attack that reduced his hours from 70 hours per week to 40.<sup>16</sup> Upon returning to work, he alleged that two other employees harassed him and pressured him to work overtime and double shifts. He alleged that while being harassed he suffered a second heart attack and that as he received treatment in

<sup>5</sup> IRC § 61(a)(1). See, e.g., *Nelson v. U.S.*, 392 Fed. Appx. 681 (11th Cir. 2010), *aff'g* 105 A.F.T.R.2d (RIA) 635 (N.D. Fla. 2010).

<sup>6</sup> IRC § 61(a)(4). See, e.g., *Alonim v. Comm'r*, T.C. Memo. 2010-190.

<sup>7</sup> IRC § 61(a)(11). See, e.g., *Buckardt v. Comm'r*, T.C. Memo. 2010-145, *appeal docketed* (9th Cir. Sept. 15, 2010).

<sup>8</sup> See, e.g., *Parkinson v. Comm'r*, T.C. Memo. 2010-142.

<sup>9</sup> See Treas. Reg. § 1.104-1(c) (damages received, for purposes of IRC § 104(a)(2), means amounts received “through prosecution of a legal suit or action based upon tort or tort type rights or through a settlement agreement entered into in lieu of such prosecution.”)

<sup>10</sup> IRC § 104(a)(2).

<sup>11</sup> Pub. L. No. 104-188, § 1605(a), 110 Stat. 1755, 1838 (1996).

<sup>12</sup> H.R. Rep. No. 104-586, at 143-44 (1996).

<sup>13</sup> H.R. Conf. Rep. No. 104-737, at 301 (1996). Note, however, that IRC § 104(a)(2) excludes from income damages, up to the cost of medical treatment for which a deduction under IRC § 213 was allowed for any prior taxable year, for mental or emotional distress causing physical injury.

<sup>14</sup> See, e.g., *Green v. Comm'r*, 507 F.3d 857 (5th Cir. 2007), *aff'g* T.C. Memo. 2005-250.

<sup>15</sup> T.C. Memo. 2010-142.

<sup>16</sup> *Parkinson v. Comm'r*, T.C. Memo. 2010-142.

the emergency room, one employee continued to call him and demand he return to work or face disciplinary action. The taxpayer eventually resigned from his job due to being disabled by the second heart attack. He settled with his former employer, and in 2005 received an installment payment under the settlement agreement. He did not report the payment on his 2005 income tax return, on the theory that the payment was for physical injuries.<sup>17</sup>

Because the parties disagreed on the characterization of the settlement payments, the court looked to the employer's intent in making the payment.<sup>18</sup> The settlement agreement contained no specific allocation of the payments other than to characterize them as "as noneconomic damages and not as wages or other income."<sup>19</sup> The Tax Court then looked to the contents of the taxpayer's complaint for insight into what the settlement payment was for, and determined that at least 50 percent of the complaint focused on the physical ailments the taxpayer suffered. This led the court to conclude that the employer knew it was paying for both the physical and emotional consequences of the actions of the two employees. Moreover, the Tax Court immediately recognized that the taxpayer's "heart attack and its physical aftereffects constitute physical injury or sickness rather than mere subjective sensations or symptoms of emotional distress." Thus, the taxpayer was able to show that a portion of the settlement proceeds was in lieu of damages for physical injury. Consequently, 50 percent of the payment was excluded from his gross income.<sup>20</sup>

As illustrated by taxpayers continuing to litigate issues involving the characterization of settlement damages year in and year out, the question of when damage awards can be excluded from gross income continues to confuse taxpayers. Even when taxpayers seek legal advice before filing a complaint for damages or accepting settlement proceeds, they may not understand how to characterize the damages in the complaint in order for them to be excludable under IRC § 104(a)(2), or may be confused about the proper tax treatment of the proceeds. For example, in *Espinoza v. Commissioner*, the taxpayer's attorney informed the taxpayer and her family that her settlement proceeds would not be taxed.<sup>21</sup> Even though the taxpayer received Form 1099-MISC from the payor, she did not realize she would be taxed on the settlement award until she received a notice of deficiency.<sup>22</sup>

### Discharge of Indebtedness

We reviewed four cases in which taxpayers disputed the IRS's determination that a discharge of indebtedness was taxable income. Taxpayers prevailed in full in only one of these cases. Generally, a taxpayer must include income from discharge of indebtedness

<sup>17</sup> *Parkinson v. Comm'r*, T.C. Memo. 2010-142.

<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> 636 F.3d 747 (5th Cir. 2011), *aff'g* T.C. Memo. 2010-53.

<sup>22</sup> *Espinoza v. Comm'r*, 636 F.3d 747 (5th Cir. 2011), *aff'g* T.C. Memo. 2010-53.

when calculating gross income,<sup>23</sup> but in certain circumstances cancellation of indebtedness income may be excluded. In this regard, IRC § 108(a) provides that a taxpayer may exclude, subject to limitations, income from the discharge of indebtedness if the discharge occurs in a bankruptcy case, when the taxpayer is insolvent, or if the indebtedness is qualified farm or business real estate debt or qualified principal residence indebtedness.<sup>24</sup>

The burden of proof is on the taxpayer to show that any of the exceptions in IRC § 108(a) apply.<sup>25</sup> For example, in *Oglesby v. Commissioner*, the taxpayer had discharge of indebtedness income from settling a debt for less than he owed.<sup>26</sup> The taxpayer admitted that he settled the debt for less than he owed and did not argue that he qualified for any exception.<sup>27</sup> Consequently, the taxpayer was required to include the discharge of indebtedness income in his gross income.<sup>28</sup>

### Parsonage Income

The court issued decisions in at least two cases concerning the excludability of parsonage income.<sup>29</sup> IRC § 107 provides an exclusion from income for the rental value of parsonages. A minister of the gospel may exclude from gross income the rental value of a home provided to him or the rental allowance provided to him up to the amount that he uses it to rent or provide a home, insofar as the parsonage income is part of his compensation package.<sup>30</sup>

In *Driscoll v. Commissioner*,<sup>31</sup> a case of first impression, the taxpayers were a husband and wife and the husband was a minister who received a parsonage allowance as part of his compensation from his employer, a tax-exempt organization under IRC § 501(a). Mr. Driscoll excluded the allowance from his income under IRC § 107 and used the allowance to provide a primary residence and a second home on a lake for his family. The IRS determined a deficiency in income for the portion of the parsonage allowance used for the lake home in each of the tax years at issue. In denying the exclusion from gross income for the portion of the parsonage allowance used to provide the lake home, the IRS took the position that exclusions from income should be narrowly construed and that the plain language

<sup>23</sup> IRC § 61(a)(12).

<sup>24</sup> IRC § 108(a)(1)(A)-(E).

<sup>25</sup> U.S. Tax Court Rules of Practice and Procedure, Rule 142(a).

<sup>26</sup> T.C. Memo. 2011-93.

<sup>27</sup> *Oglesby v. Comm'r*, T.C. Memo. 2011-93.

<sup>28</sup> *Id.*

<sup>29</sup> See *Chambers v. Comm'r*, T.C. Memo. 2011-114; *Driscoll v. Comm'r*, 135 T.C. 557 (2010), appeal docketed (11th Cir. May 24, 2011).

<sup>30</sup> IRC § 107. Recent litigation has challenged the constitutionality of IRC § 107 under the Establishment Clause of the Constitution. See *Freedom from Religion Foundation, Inc. v. Geithner*, 715 F. Supp. 2d 1051 (E.D. Cal. 2010), stipulated dismissal, June 17, 2011. The Establishment Clause of the First Amendment to the United States Constitution prohibits the government from making any law respecting an establishment of religion, that is, the government may neither make laws that favor nor disadvantage religious institutions. U.S. Const. amend. I. Section 107 of the IRC provides an exclusion from gross income available only to ministers of the gospel. Although the case was eventually dismissed for lack of standing, findings during an initial motion to dismiss hearing indicated that the court could ultimately hold for the plaintiffs (a nonprofit organization and its members that advocate for the separation of church and state) if they bring suit with proper standing. It is likely that constitutional challenges to IRC § 107 will be brought again in the future.

<sup>31</sup> 135 T.C. 557 (2010), appeal docketed (11th Cir. May 24, 2011).

of IRC § 107 permits the exclusion of the allowance up to the amount used to provide “a home,” indicating a singular residence.<sup>32</sup>

The court found for the taxpayers, holding that nothing in the plain language of IRC § 107 prohibits a taxpayer from using a parsonage allowance to provide more than one residence.<sup>33</sup> The court turned to the United States Code (USC) which states: “In determining the meaning of any Act of Congress, unless the context indicates otherwise—words importing the singular include and apply to several persons, parties, or things.”<sup>34</sup> The court concluded that Congress did not intend to limit the parsonage exclusion to one home and in fact, the language in the USC negated the position of the IRS that “a home” indicated only the singular “one home.”<sup>35</sup> The government has appealed the decision in *Driscoll v. Commissioner*, leaving the question of the excludability of the parsonage allowance in regards to a second home open for interpretation by the 11th Circuit Court of Appeals.

#### Gain from Sale of Principal Residence

Generally, gain realized on the sale of property is included in a taxpayer’s gross income.<sup>36</sup> IRC § 121(a), however, allows a taxpayer to exclude from income a gain on the sale or exchange of property if the taxpayer has owned and used the property as his or her principal residence for at least two of the five years immediately preceding the sale. The maximum exclusion is \$500,000 for a husband and wife who file a joint return for the year of the sale or exchange.<sup>37</sup>

A married couple filing a joint return is eligible for the \$500,000 exclusion on the sale or exchange of property they owned and used as their principal residence if either spouse meets the ownership requirement, both spouses meet the use requirement, and neither spouse claimed an exclusion under IRC § 121(a) during the two-year period before the sale or exchange.<sup>38</sup> In *Gates v. Commissioner*, the Tax Court acknowledged that IRC § 121 does not define two critical terms—“property” and “principal residence.”<sup>39</sup> The taxpayers in *Gates* were a husband and wife who had lived together for two years before demolishing their house and building a new one on the same property. Mr. and Mrs. Gates then sold the new house without ever living in it and did not report the gain from the sale.

The IRS argued that Mr. and Mrs. Gates did not sell property they had owned and used as their principal residence for the required two-year period and therefore were ineligible for the exclusion from gross income. Applying principles of statutory construction, the

<sup>32</sup> *Driscoll v. Comm’r*, 135 T.C. 557, 563-64 (2010), *appeal docketed* (11th Cir. May 24, 2011).

<sup>33</sup> *Id.*

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

<sup>35</sup> *Id.*

<sup>36</sup> IRC § 61(a)(3).

<sup>37</sup> IRC § 121(b)(2)(A).

<sup>38</sup> IRC § 121(b)(2)(A)(i)-(iii).

<sup>39</sup> 135 T.C. 1 (2010), *appeal docketed*, No. 10-73209 (9th Cir. Oct. 19, 2010).

Tax Court found that the terms “property” and “principal residence” could have multiple meanings.<sup>40</sup> Turning then to the legislative history for IRC § 121 and its predecessor provisions, the Tax Court concluded that Congress intended the terms “property” and “principal residence” to mean a house or other dwelling in which the taxpayer actually lives.<sup>41</sup> Consequently, the taxpayers were not entitled to the exclusion from gross income because the house they sold had never been used as their principal residence.

## CONCLUSION

Taxpayers litigate many of the same gross income issues year after year due to the complex nature of what constitutes gross income. This report has highlighted some of the main areas of confusion under IRC § 61, though these issues are not discrete. The National Taxpayer Advocate has previously recommended a legislative change that would clarify the tax treatment of court awards and settlements by permitting taxpayers to exclude any payments received as a settlement or judgment for mental anguish, emotional distress, or pain and suffering.<sup>42</sup>

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<sup>40</sup> *Gates v. Comm’r*, 135 T.C. 1, 7 (2010), *appeal docketed*, No. 10-73209 (9th Cir. Oct. 19, 2010).

<sup>41</sup> *Id.*

<sup>42</sup> National Taxpayer Advocate Annual 2009 Report to Congress 351-356 (Legislative Recommendation: *Exclude Settlement Payments for Mental Anguish, Emotional Distress, and Pain and Suffering from Gross Income*).

MLI  
#6**Accuracy-Related Penalty Under Internal Revenue Code  
Section 6662(B)(1) and (2)****SUMMARY**

Internal Revenue Code (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.<sup>1</sup> We did not analyze these other accuracy-related penalties because during our review period of June 1, 2010, through May 31, 2011, taxpayers litigated these penalties less frequently than the negligence and substantial understatement penalties.

**PRESENT LAW**

The amount of an accuracy-related penalty equals 20 percent of the portion of the underpayment attributable to the taxpayer's negligence or disregard of rules or regulations, or a substantial understatement.<sup>2</sup> The IRS may assess penalties under both IRC § 6662(b)(1) and IRC § 6662(b)(2), but the total penalty rate cannot exceed 20 percent (*i.e.*, the penalties are not "stackable").<sup>3</sup> Generally, taxpayers are not subject to the accuracy-related penalty if they establish that they had reasonable cause for the underpayment and acted in good faith.<sup>4</sup> In addition, a taxpayer will be subject to the negligence component of the penalty only on the portion of the underpayment attributable to negligence. For example, if a taxpayer wrongly reports multiple items of income, some errors may be justifiable mistakes while others might be the result of negligence; the penalty applies only to the latter.

**Negligence**

The IRS may impose the IRC § 6662(b)(1) negligence penalty if it concludes that a taxpayer's negligence or disregard of the rules or regulations caused the underpayment.<sup>5</sup> Negligence includes a failure to make a reasonable attempt to comply with internal revenue laws, including a failure to keep adequate books and records or to substantiate items that gave rise to the underpayment.<sup>6</sup> Strong indicators of negligence include instances where a taxpayer failed to report income on a tax return that a payor reported on an information

<sup>1</sup> IRC § 6662(b)(3) authorizes a penalty for any substantial valuation misstatement for income taxes; IRC § 6662(b)(4) authorizes a penalty for any substantial overstatement of pension liabilities; and IRC § 6662(b)(5) authorizes a penalty for any substantial valuation understatement of estate or gift taxes.

<sup>2</sup> IRC § 6662(b)(1) (negligence or disregard of rules or regulations) and IRC § 6662(b)(2) (substantial understatement).

<sup>3</sup> Treas. Reg. § 1.6662-2(c). The penalty rises to 40 percent if any portion of the underpayment is due to a "gross valuation misstatement." See IRC § 6662(h)(1).

<sup>4</sup> IRC § 6664(c)(1).

<sup>5</sup> IRC § 6662(c) defines negligence as "any failure to make a reasonable attempt to comply with the provisions of this title, and 'disregard' includes any careless, reckless, or intentional disregard."

<sup>6</sup> Treas. Reg. § 1.6662-3(b)(1).

return as defined in IRC § 6724(d)(1),<sup>7</sup> or failed to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion.<sup>8</sup> The IRS can also consider various other factors in determining whether the taxpayer's actions were negligent.<sup>9</sup>

### Substantial Understatement

Generally, an “understatement” is the difference between (1) the correct amount of tax and (2) the amount of tax reported on the return, reduced by any rebate.<sup>10</sup> Understatements are usually reduced by the portion of an understatement attributable to (1) an item for which the taxpayer had substantial authority; or (2) any item for which the taxpayer adequately disclosed the relevant facts affecting the item's tax treatment in the return or an attached statement, and the taxpayer had a reasonable basis for the tax treatment.<sup>11</sup> For individuals, the understatement of tax is substantial if it exceeds the greater of \$5,000 or ten percent of the tax required to be shown on the return.<sup>12</sup> For corporations (other than S corporations or personal holding companies), an understatement is substantial if it exceeds the lesser of ten percent of the tax required to be shown on the return or \$10,000,000.<sup>13</sup>

For example, if the correct amount of tax should have been \$10,000 and an individual taxpayer reported \$6,000, the substantial understatement penalty under IRC § 6662(b)(2) would not apply because although the \$4,000 shortfall is more than the ten percent test (\$1,000 is ten percent of \$10,000), it is less than the fixed \$5,000 threshold. Conversely, if the same individual reported a tax of \$4,000, the substantial understatement penalty would apply because the \$6,000 shortfall is more than \$5,000, which is the greater of the two thresholds.

### Reasonable Cause

The accuracy-related penalty does not apply to any portion of an underpayment where the taxpayer acted with reasonable cause and in good faith.<sup>14</sup> A reasonable cause determination takes into account all of the pertinent facts and circumstances.<sup>15</sup> Generally, the most important factor is the extent of the taxpayer's effort to determine the proper tax liability.<sup>16</sup>

<sup>7</sup> IRC § 6724(d)(1) defines an information return by cross-referencing various other sections of the Code that define information returns (e.g., IRC § 6724(d)(1)(A)(ii) references IRC § 6042(a)(1) for reporting of dividend payments).

<sup>8</sup> Treas. Reg. §§ 1.6662-3(b)(1)(i) and (ii).

<sup>9</sup> These factors include the taxpayer's history of noncompliance; the taxpayer's failure to maintain adequate books and records; actions taken by the taxpayer to ensure the tax was correct; and whether the taxpayer had an adequate explanation for underreported income. Internal Revenue Manual (IRM) 4.10.6.2.1 (May 14, 1999).

<sup>10</sup> IRC § 6662(d)(2)(A).

<sup>11</sup> IRC § 6662(d)(2)(B). No reduction is permitted, however, for any item attributable to a tax shelter. See IRC § 6662(d)(2)(C)(i).

<sup>12</sup> IRC §§ 6662(d)(1)(A)(i) and (ii).

<sup>13</sup> IRC §§ 6662(d)(1)(B)(i) and (ii).

<sup>14</sup> IRC § 6664(c)(1).

<sup>15</sup> Treas. Reg. § 1.6664-4(b)(1).

<sup>16</sup> *Id.*

### Penalty Assessment and the Litigation Process

In general, the IRS proposes the accuracy-related penalty as part of its examination process<sup>17</sup> and through its Automated Underreporter (AUR) computer system.<sup>18</sup> Before a taxpayer receives a notice of deficiency, he or she has opportunities to engage the IRS on the merits of the penalty.<sup>19</sup> Once the IRS concludes an accuracy-related penalty is warranted, it must follow the same deficiency procedures it uses with other assessments (*i.e.*, IRC §§ 6211-6213).<sup>20</sup> Thus, the IRS must send a notice of deficiency with the proposed adjustments and inform the taxpayer that he or she has 90 days to petition the United States Tax Court to challenge the assessment.<sup>21</sup> Alternatively, taxpayers may seek judicial review through refund litigation.<sup>22</sup> Under certain circumstances, a taxpayer can request an administrative appeal of IRS collection procedures (and the underlying liability) through a Collection Due Process (CDP) hearing.<sup>23</sup>

### Burden of Proof

In court proceedings, the IRS bears the initial burden of production regarding the accuracy-related penalty.<sup>24</sup> The IRS must first present sufficient evidence to establish that the penalty is warranted. The burden of proof then shifts to the taxpayer to establish any exception to the penalty, such as reasonable cause.<sup>25</sup>

<sup>17</sup> IRM 20.1.5.3(1) and (2) (July 1, 2008).

<sup>18</sup> The AUR is an automated program that identifies discrepancies between the amounts that taxpayers reported on their returns and what payors reported via Form W-2, Form 1099, and other information returns. See IRM 4.19.2 (Aug. 5, 2011). IRC § 6751(b)(1) provides the general rule that IRS employees must have written supervisory approval before assessing any penalty. However, IRC § 6751(b)(2)(B) allows an exception for situations where the IRS can calculate a penalty automatically “through electronic means.” The IRS interprets this exception as allowing it to use its AUR system to propose the substantial understatement and negligence components of the accuracy-related penalty without human review. If a taxpayer responds to an AUR-proposed assessment, the IRS first involves its employees at that point to determine whether the penalty is appropriate. If the taxpayer does not respond timely to the notice, the computers automatically convert the proposed penalty to an assessment. See National Taxpayer Advocate 2007 Annual Report to Congress 259 (“Although automation has allowed the IRS to more efficiently identify and determine when such underreporting occurs, the IRS’s over-reliance on automated systems rather than personal contact has led to insufficient levels of customer service for taxpayers subject to AUR. It has also resulted in audit reconsideration and tax abatement rates that are significantly higher than those of all other IRS examination programs.”).

<sup>19</sup> For example, when the IRS proposes to adjust a taxpayer’s liability, including additions to tax such as the accuracy-related penalty, it typically sends a notice (“30-day letter”) of proposed adjustments to the taxpayer. A taxpayer has 30 days to contest the proposed adjustments to the IRS Office of Appeals, during which time he or she may raise issues related to the deficiency, including any reasonable cause defense to a proposed penalty. If the issue is not resolved after the 30-day letter, the IRS sends a statutory notice of deficiency (“90-day letter”) to the taxpayer. See IRS Pub. 5, *Your Appeal Rights and How to Prepare a Protest If You Don’t Agree* (Jan. 1999); IRS Pub. 3498, *The Examination Process* (Nov. 2004).

<sup>20</sup> IRC § 6665(a)(1).

<sup>21</sup> IRC § 6213(a). A taxpayer has 150 days instead of 90 to petition the Tax Court if the IRS sent the notice of deficiency to an address outside the United States.

<sup>22</sup> Taxpayers may litigate an accuracy-related penalty by paying the tax liability (including the penalty) in full, filing a timely claim for refund, and then instituting a refund suit in the appropriate United States District Court or the Court of Federal Claims. 28 U.S.C. § 1346(a)(1); IRC § 7422(a); *Flora v. U.S.*, 362 U.S. 145 (1960) (requiring full payment of tax liabilities as a prerequisite for jurisdiction over refund litigation).

<sup>23</sup> IRC §§ 6320 and 6330 provide for due process hearings in which a taxpayer may raise a variety of issues including the underlying liability, provided the taxpayer did not receive a statutory notice of deficiency or did not otherwise have an opportunity to dispute such liability. IRC § 6330(c)(2).

<sup>24</sup> IRC § 7491(c) provides that “the Secretary shall have the burden of production in any court proceeding with respect to the liability of any individual for any penalty, addition to tax, or additional amount imposed by this title.”

<sup>25</sup> IRC § 7491(c). See also Tax Court Rule 142(a).

## ANALYSIS OF LITIGATED CASES

From June 1, 2010, through May 31, 2011, we identified 55 cases where taxpayers litigated the negligence, disregard of rules or regulations, or substantial understatement components of the accuracy-related penalty. The IRS prevailed in full in 36 cases (65 percent), the taxpayers prevailed in full in 14 cases (25 percent), and five cases (nine percent) resulted in split decisions. Taxpayers prevailed partially or fully in 35 percent of the penalty disputes. Table 6 in Appendix III provides a detailed list of these cases.

Taxpayers appeared *pro se* (without representation) in 24 of the 55 cases (43 percent) and convinced the court to dismiss or reduce the penalty in six (25 percent) of their cases. Represented taxpayers fared much better, achieving full or partial relief from the penalty in 13 (42 percent) of their cases.

In some cases, the court was unclear on whether subsection (b)(1) or (b)(2) of the accuracy-related penalty was applied. Regardless of the subsection at issue, the analysis of reasonable cause is the same. Therefore, we have combined our analyses of reasonable cause for the negligence and substantial understatement cases.

### Reasonable Cause

#### *Adequacy of Records and Substantiation of Deductions for Reasonable Cause and as Proof of Taxpayer's Good Faith*

Taxpayers are required to maintain records sufficient to establish the amount of gross income, deductions, and credits claimed on a return.<sup>26</sup> Taxpayers were most successful in establishing a defense for an underpayment when they produced adequate records or proved they made a reasonable attempt to comply with the requirements of the law. For example, in *Stroff v. Commissioner*,<sup>27</sup> the taxpayer was a self-employed handyman who claimed deductions for labor expenses. The taxpayer produced a list of his clients, along with his weekly planners, and testified regarding the nature of his handyman business. While the court noted his substantiation fell short of being adequate, his recordkeeping nonetheless was a reasonable attempt to comply with the law. Therefore, the court declined to impose the penalty.

Conversely, in other cases, the court found that the taxpayer did not show good faith in attempting to comply with tax laws, and had no reasonable cause when presenting inadequate records or insufficient substantiation. For example, in *Viralam v. Commissioner*,<sup>28</sup> the taxpayers claimed a charitable contribution deduction but failed to maintain any records to substantiate the contribution. The Tax Court concluded the failure to substantiate was an indication of negligence, and consequently, sustained the IRS's determination that the taxpayers were liable for the accuracy-related penalty. Similarly, the taxpayer in *Whitaker*

<sup>26</sup> IRC § 6001; Treas. Reg. § 1.6001-1(a).

<sup>27</sup> T.C. Memo. 2011-80.

<sup>28</sup> 136 T.C. No. 8 (2011).

*v. Commissioner*,<sup>29</sup> the owner of a mortgage brokerage, failed to produce records substantiating her Schedule C gross receipts, Schedule C deductions, long-term capital gain, and Schedule E rental expenses. The Tax Court upheld the imposition of the accuracy-related penalty.

### *Reliance on Advice of a Tax Professional as Reasonable Cause*

Reliance on a tax professional was another commonly litigated example of reasonable cause. To qualify for reliance on a tax professional under the reasonable cause exception, the taxpayers must establish that: (1) they provided all necessary information to the tax professional; (2) the tax professional was competent with sufficient expertise; and (3) the taxpayers relied in good faith on the tax professional's opinion or tax return preparation.<sup>30</sup> The taxpayer's education, sophistication, and business experience are relevant in determining whether the taxpayer's reliance on tax advice was reasonable.<sup>31</sup>

In *NPR Investments, LLC v. United States*,<sup>32</sup> the IRS argued that reliance on a tax professional was not appropriate because the transaction was "too good to be true." In that case, the taxpayers (partners in a limited liability company (LLC) treated as a partnership for tax purposes) participated in a foreign currency option investment strategy. When the partners withdrew from the LLC, they received cash and foreign currencies representing the fair market value of their interests. The partners obtained a legal opinion that detailed the proper tax treatment of their investments. Because the partners had no tax expertise, they consulted their accountant regarding the legal opinion and their accountant advised them that their tax position was more likely than not correct. The district court concluded the partners were not liable for the accuracy-related penalty, finding that the partners proved "their good faith in relying on the advice of qualified tax accountants and tax lawyers."<sup>33</sup>

Taxpayers cannot rely on the advice of an advisor with an inherent conflict of interest, such as an advisor who financially benefits from the transaction.<sup>34</sup> For example, in *Canal Corporation v. Commissioner*,<sup>35</sup> the taxpayer (a corporation), formed an LLC. An accounting firm advised the taxpayer on structuring the transaction. Based on the opinion of the accounting firm, the taxpayer treated the transaction as a tax-free contribution of property to a partnership and did not report any income from the transaction on its tax return. In concluding that the taxpayer was subject to the accuracy-related penalty for a substantial understatement, the court found it significant that the tax professional from the accounting firm who provided the tax advice had also been the auditor of the LLC. Moreover, that tax

<sup>29</sup> T.C. Memo. 2010-209.

<sup>30</sup> *Neufeld v. Comm'r*, T.C. Memo. 2008-79; *Neonatology Associates, P.A. v. Comm'r*, 115 T.C. 43, 99 (2000) (citations omitted), *aff'd*, 299 F.3d 221 (3d Cir. 2002); Treas. Reg. § 1.6664-4(c)(1).

<sup>31</sup> Treas. Reg. § 1.6664-4(c)(1). See also IRM 20.1.5.6.1(6) (July 1, 2008).

<sup>32</sup> 732 F. Supp. 2d 676 (E.D. Tex. 2010).

<sup>33</sup> 732 F. Supp. 2d 676, 693 (E.D. Tex. 2010).

<sup>34</sup> See *Tigers Eye Trading, LLC v. Comm'r*, T.C. Memo. 2009-21, and the cases cited therein.

<sup>35</sup> 135 T.C. 199 (2010), *appeal docketed*, No. 10-2253 (4th Cir. Oct. 29, 2010).

professional had been “intricately involved in drafting the joint venture agreement, the operating agreement, and the indemnity agreement. In essence, [the tax professional] issued an opinion on a transaction he helped plan without the normal give-and-take in negotiating terms with an outside party.”<sup>36</sup>

### **Reliance on Tax Preparation Software**

Reliance on tax return preparation software, much like reliance on a tax professional, does not necessarily entitle the taxpayer to escape liability for accuracy-related penalties. We reviewed three cases where the taxpayer claimed reliance on software as evidence of reasonable cause and good faith, and in each case, the Tax Court upheld the penalty. For example, in *Anyika v. Commissioner*,<sup>37</sup> the taxpayers (a husband and wife) tried to blame TurboTax for the miscalculation in their income which gave rise to a substantial understatement. Yet the taxpayers did not provide any evidence showing the information they entered into TurboTax, which is a preliminary showing required to decide whether the software was in any way at fault.<sup>38</sup> Tax return preparation software is only as good as the information the taxpayer puts into it.<sup>39</sup> Misuse of tax return preparation software, whether unintentional or not, is no defense to accuracy-related penalties.<sup>40</sup> Consequently, the Tax Court found the taxpayers’ reliance on TurboTax was not reasonable cause for their underpayment.

### **Tax Shelter Penalty Litigation**

We identified at least one case where accuracy-related penalties were assessed in the tax shelter context.<sup>41</sup> To discern whether the taxpayer acted with reasonable cause or in good faith with regard to shelters, one may look at all circumstances, including the actions of the taxpayer and the pass-thru entity.<sup>42</sup> In *Fidelity International Currency Advisor A Fund, LLC v. United States*,<sup>43</sup> the taxpayers were partners who held significant amounts of corporate stock and entered into transactions to avoid large tax liabilities on the sale of that stock. The court found that the conduit transaction was a tax shelter because its only purpose was to avoid tax liability. Consequently, there was no reduction in the accuracy-related penalty for relying on substantial authority.<sup>44</sup>

<sup>36</sup> *Canal Corp. v. Comm’r*, 135 T.C. 199 (2010), *appeal docketed*, No. 10-2253 (4th Cir. Oct. 29, 2010).

<sup>37</sup> T.C. Memo. 2011-69.

<sup>38</sup> *Paradiso v. Comm’r*, T.C. Memo. 2005-187 (involving the reasonable cause component of the failure to file penalty, IRC § 6651(a)(1)).

<sup>39</sup> *Bunney v. Comm’r*, 114 T.C. 259, 267 (2000).

<sup>40</sup> *Lam v. Comm’r*, T.C. Memo. 2010-82.

<sup>41</sup> IRC § 6662(d)(2)(C). A tax shelter is an entity or transaction whose “significant purpose...is the avoidance or evasion of Federal income tax.”

<sup>42</sup> Treas. Reg. § 1.6664-4(e).

<sup>43</sup> 747 F. Supp. 2d 49 (D. Mass. 2010).

<sup>44</sup> See IRC § 6662(d)(2)(C)(i).

## CONCLUSION

In the cases reviewed, the courts generally upheld deficiency determinations or portions of the deficiency determined by the IRS. However, the courts at times overruled the IRS in full or in part in regard to the accuracy-related penalties.

These cases indicate that although the taxpayer may have been incorrect on the underlying tax issue, if the taxpayer made a legitimate attempt to ascertain the correct amount of tax, the taxpayer often escaped liability for the penalty. Adequacy of records and reliance on tax professionals were the preeminent bases for finding reasonable cause. In addition, factors such as the knowledge of the taxpayer and the circumstances surrounding the taxpayer's reliance on a professional were also balanced by the courts. In the few cases where the taxpayer prevailed on the penalty issue, the IRS should take a closer look at the court's rationale. While the existence of reasonable cause is very fact-specific, those cases may offer lessons to be learned, which the IRS can incorporate into the Internal Revenue Manual and training materials.

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

Internal Revenue Code (IRC or the “Code”) § 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 issued between June 1, 2010, and May 31, 2011, which involved civil actions to enforce federal tax liens under IRC § 7403. The courts affirmed the position of the United States in the majority of cases. Taxpayers prevailed in only three cases and three cases resulted in split decisions. This is the third year that this issue has appeared as a Most Litigated Issue in the National Taxpayer Advocate’s Annual Report to Congress.<sup>1</sup>

**PRESENT LAW**

IRC § 7403 specifically authorizes the United States to enforce a federal tax lien with respect to a taxpayer’s delinquent tax liability, or to subject any property, right, title, or interest in the property of the delinquent taxpayer to the payment of tax liability, by initiating a civil action in the appropriate United States District Court against the taxpayer.<sup>2</sup> All persons holding liens or claiming any interest in the taxpayer’s property should be named as parties to the action.<sup>3</sup> The nature of a taxpayer’s legal interest in the property subject to a lien is determined by the law of the state where the property is located.<sup>4</sup> However, once it is determined that a delinquent taxpayer has an interest in the property, federal law controls whether the property is exempt from attachment.<sup>5</sup>

The U.S. District Court may order that the property be sold by an officer of the court and the proceeds applied to the delinquent tax liability.<sup>6</sup> However, the court is not required to authorize a forced sale under all circumstances and may exercise limited equitable discretion.<sup>7</sup> In cases where the forced sale involves the interests of non-delinquent third parties, a U.S. District Court should consider the following four factors when determining whether the property should be sold:

1. The extent to which the government’s financial interests would be prejudiced if they were relegated to a forced sale of the partial interest of the delinquent taxpayer;

<sup>1</sup> See National Taxpayer Advocate 2010 Annual Report to Congress 483-486; National Taxpayer Advocate 2009 Annual Report to Congress 465-470.

<sup>2</sup> IRC § 7403(a); Treas. Reg. § 301.7403-1(a). Such action may be initiated regardless of whether levy has been made.

<sup>3</sup> IRC § 7403(b).

<sup>4</sup> *U.S. v. National Bank of Commerce*, 472 U.S. 713, 722 (1985).

<sup>5</sup> *U.S. v. Rodgers*, 461 U.S. 677 (1983). Similarly, federal tax liens can attach to property exempt from the reach of creditors under state law, including property held by a delinquent taxpayer as a tenant by the entirety. *U.S. v. Craft*, 535 U.S. 274 (2002).

<sup>6</sup> IRC § 7403(c).

<sup>7</sup> *Rodgers*, 461 U.S. at 711.

2. Whether the innocent third party with a separate interest in the property, in the normal course of events, has a legally recognized expectation that the property would not be subject to a forced sale by the delinquent taxpayer or his or her creditors;
3. The likely prejudice to the third party in personal dislocation costs and inadequate compensation; and
4. The relative character and value of the non-liable and liable interests held in the property.<sup>8</sup>

The United States may bid at the sale of the property when it holds a first lien.<sup>9</sup> However, the amount of the bid is limited to the amount of the lien, plus selling expenses.<sup>10</sup> If any of the taxpayer's other creditors institute an action to foreclose their lien on the property which is subject to the federal tax lien, and the United States is not a party, the United States may intervene as if it had originally been joined as a party<sup>11</sup> and may remove the case to the U.S. District Court if such action was instituted in a state court.<sup>12</sup> However, junior federal tax liens may be effectively extinguished in a foreclosure and sale under state law, even if the United States is not a party to the proceeding.<sup>13</sup> The Code also specifically authorizes the court to appoint a receiver to enforce the lien and, upon the government's certification that it is in the public interest, the court may appoint a receiver with all powers of a receiver in equity to preserve and operate the property prior to sale.<sup>14</sup>

### ANALYSIS OF LITIGATED CASES

We reviewed 48 opinions entered between June 1, 2010, and May 31, 2011, in civil actions to enforce federal tax liens. Table 7 in Appendix III contains a detailed list of those cases. In 25 cases, taxpayers represented themselves (*pro se*), while 23 of the 48 taxpayers were represented by counsel. Taxpayers with representation received full relief in two cases and partial relief in two cases, while *pro se* taxpayers received full relief in one case and partial relief in one case.

The issue of whether it was appropriate to foreclose the federal tax lien against the taxpayer's real property was the most prevalent issue. The courts considered this issue in 47

<sup>8</sup> *Rodgers*, 461 U.S. at 709-11.

<sup>9</sup> IRC § 7403(c).

<sup>10</sup> *Id.*

<sup>11</sup> IRC § 7424; 28 U.S.C. § 2410.

<sup>12</sup> 28 U.S.C. § 1444. However, if the application of the United States to intervene is denied, the adjudication will have no effect upon the federal tax lien on the property. IRC § 7424.

<sup>13</sup> *U.S. v. Brosnan*, 363 U.S. 237 (1960).

<sup>14</sup> IRC §§ 7403(d) and 7402(a).

cases, with the government prevailing fully in 39 of these cases.<sup>15</sup> A typical case is *United States v. Benoit*,<sup>16</sup> in which the government filed an action to foreclose its tax liens and sell the taxpayer's real property to which the liens had attached. First, the court determined that the government had correctly assessed the taxpayer's liabilities and the tax assessments remained unpaid.<sup>17</sup> Thus, federal tax liens attached to the taxpayer's property.<sup>18</sup> The court then observed that the assessments were made after notice and demand and within the applicable statute of limitations period.<sup>19</sup> Thus, the court granted the government's motion for summary judgment and ordered the foreclosure of the valid federal tax liens against the taxpayer's real property.

In *United States v. Johnson*,<sup>20</sup> the court issued a split ruling on a motion for summary judgment. According to the court, the collection period had expired regarding one tax year at issue, but remained open with respect to nine years in question. Further, a genuine issue of material fact remained regarding whether the taxpayer had executed a valid extension of the collection period for three other years.

In a number of cases, the courts considered the equitable factors under the United States Supreme Court decision in *United States v. Rodgers*.<sup>21</sup> For example, in *United States v. Winsper*,<sup>22</sup> the court applied the *Rodgers* factors and denied the government's motion for foreclosure of federal tax liens on the taxpayer's home, a home he owned with his wife who did not have any outstanding federal tax debts. The court declined to authorize the foreclosure, finding that two of the *Rodgers* factors weighed against relief. First, the court found that the wife, as joint owner of the property, had a legally recognized expectation that the property would not be subject to forced sale given the fact that in Kentucky, where the property is located, courts have established a policy against the foreclosure of a marital residence to satisfy the wrongdoing of only one spouse. Second, the sale was likely to generate a relatively small amount of proceeds, and the wife's portion of the proceeds would not be

<sup>15</sup> In eight cases, the United States Courts of Appeals affirmed the trial courts' decisions in favor of the government. See *U.S. v. Christiansen*, 107 A.F.T.R.2d (RIA) 840 (11th Cir. 2011) (per curiam), *aff'g* 107 A.F.T.R.2d (RIA) 937 (M.D. Fla. 2010); *U.S. v. Morgan*, 419 Fed. Appx. 958 (11th Cir. 2011) (per curiam), *aff'g* 105 A.F.T.R.2d (RIA) 442 (M.D. Fla. 2010); *U.S. v. Wesselman*, 406 Fed. Appx. 64 (7th Cir. 2011), *aff'g* 105 A.F.T.R.2d (RIA) 2021 (S.D. Ill. 2010); *U.S. v. Zurn*, 107 A.F.T.R. 2d (RIA) 2127 (9th Cir. 2011), *aff'g* 103 A.F.T.R.2d (RIA) 939 (C.D. Cal. 2009); *U.S. v. Barr*, 617 F.3d 370 (6th Cir. 2010), *aff'g* 102 A.F.T.R.2d (RIA) 6078 (E.D. Mich. 2008), *reh'g en banc denied*, 106 A.F.T.R.2d (RIA) 6893 (6th Cir. 2010), *cert. denied*, 131 S. Ct. 1678 (2011); *U.S. v. Niamatali*, 389 Fed. Appx. 334 (5th Cir. 2010) (per curiam), *aff'g* 07-00108 (S.D. Tex. 2009); *U.S. v. Neal*, 391 Fed. Appx. 569 (8th Cir. 2010) (per curiam), *aff'g* 103 A.F.T.R.2d (RIA) 643 (W.D. Ark. 2008); *U.S. v. Wheeler*, 403 Fed. Appx. 301 (9th Cir. 2010), *aff'g* 07-06384 (C.D. Cal. 2008).

<sup>16</sup> 107 A.F.T.R.2d (RIA) 1056 (S.D. Cal. 2010), *reconsideration denied by* 107 A.F.T.R.2d (RIA) 2577 (S.D. Cal. 2011), *appeal dismissed* (9th Cir. Oct. 19, 2011).

<sup>17</sup> Once the government introduces into evidence a Certificate of Assessments and Payments (Form 4340), it establishes a presumption of correctness with respect to the tax assessment and constitutes a *prima facie* case of liability on the part of the taxpayer. *Hughes v. United States*, 953 F.2d 531, 535 (9th Cir. 1991). The burden then shifts to the taxpayer to show that the assessment was not properly made. *Id.* In *Benoit*, the government introduced the Certificate, and the taxpayer failed to produce any evidence to refute the presumption of correctness.

<sup>18</sup> If a taxpayer, after notice and demand for a payment, refuses or fails to pay, a "secret" lien that attaches to all of the taxpayer's property or rights to property arises upon assessment under IRC §§ 6321 and 6322.

<sup>19</sup> IRC § 6502.

<sup>20</sup> 107 A.F.T.R.2d (RIA) 2330 (E.D. Mo. 2011).

<sup>21</sup> 461 U.S. 677 (1983).

<sup>22</sup> 106 A.F.T.R.2d (RIA) 6945 (W.D. Ky. 2010).

sufficient to allow her to relocate to other reasonable housing. In *United States v. Porath*,<sup>23</sup> the court found the IRS held a valid federal tax lien on the taxpayer's one-half interest in his family home, despite the taxpayer's subsequent conveyance of that interest to his wife. However, the order of foreclosure allowed the Poraths to continue to live in the home so long as they maintain the property, keep it insured, and pay the real estate taxes.

Another common issue litigated by the government was foreclosure of federal tax liens against the taxpayer's property titled in the name of a nominee.<sup>24</sup> A nominee is a party that holds legal title to a property while all or some of the benefits of the property are retained by a different party, in this case the taxpayer.<sup>25</sup> In *United States v. Burnett*,<sup>26</sup> the IRS assessed federal income and employment taxes against the taxpayer and recorded notices of federal tax liens against his property. Several years later, the taxpayer, acting as attorney-in-fact for his grandmother a week prior to her death, transferred two of her properties to a trust. The United States filed suit to enforce the tax liens against the properties held by the trust arguing that the trust was simply the nominee of the taxpayer and that the taxpayer, rather than the trust, was the true beneficial owner of the properties. The taxpayer, on the other hand, argued that he never held title to the properties in question and that the trust existed for the benefit of his children. The court sided with the IRS, noting that the property was transferred to the trust for minimal consideration and in anticipation of litigation, the taxpayer continued to exercise control over the property, the taxpayer maintained a close relationship with the trust company, and the taxpayer continued to enjoy the benefits of the property. As such, the court concluded, the trust was merely the taxpayer's nominee, and the government was entitled to enforce its tax liens against the property.

Similarly, in *United States v. Felt*,<sup>27</sup> the government filed an action to foreclose its tax liens and sell the taxpayer's real property to which the liens had attached. The court found that the tax liens attached to property that was titled in the name of the Felt Trust, rather than in the name of the taxpayer. The court determined that the trust was the nominee of the taxpayer as the taxpayer transferred the property to the trust for inadequate consideration, the taxpayer and his wife resided at the property without ever paying rent, and enjoyed all the benefits of the property. Thus, the court granted the motion for summary judgment and ordered the foreclosure of the valid federal tax liens against the taxpayer's real property.

<sup>23</sup> 764 F. Supp. 2d 883 (E.D. Mich. 2011), *appeal docketed* (6th Cir. Apr. 1, 2011), *appeal dismissed* (6th Cir. Apr. 22, 2011), *appeal reinstated* (6th Cir. May 3, 2011).

<sup>24</sup> See, e.g., *U.S. v. Felt*, 107 A.F.T.R.2d (RIA) 2239 (D. Utah 2011); *U.S. v. Zimmerman*, 107 A.F.T.R.2d (RIA) 1887 (E.D. Pa. 2011), *order entered by* 2011 WL 1483349 (E.D. Pa. 2011), *motion for relief from judgment and to vacate sale filed* (E.D. Pa. Nov. 3, 2011); *U.S. v. Benice*, 106 A.F.T.R.2d (RIA) 6485 (C.D. Cal. 2010); *U.S. v. Lupi*, 105 A.F.T.R.2d (RIA) 2806 (M.D. Fla. 2010).

<sup>25</sup> See *U.S. v. Lupi*, 105 A.F.T.R.2d (RIA) 2806 (M.D. Fla. 2010).

<sup>26</sup> 106 A.F.T.R.2d (RIA) 6699 (S.D. Tex. 2010), *appeal docketed* (5th Cir. Dec. 22, 2010).

<sup>27</sup> 107 A.F.T.R.2d (RIA) 2239 (D. Utah 2011).

## CONCLUSION

Federal tax lien enforcement first appeared as a Most Litigated Issue in 2009, and enforcement activities by the IRS continue to increase each year. In fiscal year (FY) 2002, the IRS filed approximately 492,000 Notices of Federal Tax Lien (NFTLs); that number rose to nearly 1.1 million in FY 2010, an increase of nearly 125 percent in just eight years.<sup>28</sup> Between FY 2009 and FY 2010 alone, NFTL filings increased by over 130,000.<sup>29</sup> This rise in NFTL filings has led more taxpayers to contest the foreclosure actions on these liens in the federal court system. As the IRS continues to increase enforcement activities such as filing NFTLs, we expect the number of court cases involving suits to foreclose liens will also continue to increase.

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<sup>28</sup> The IRS filed 492,000 NFTLs in FY 2002 and 1,096,376 in FY 2010. Statistics of Income Data Books, Table 16b, Delinquent Collection Activities, 2002-2010.

<sup>29</sup> The IRS filed 965,618 NFTLs in FY 2009 and 1,096,376 in FY 2010. Statistics of Income Data Books, Table 16b, Delinquent Collection Activities, 2002-2010.

MLI  
#8**Relief From Joint and Several Liability Under Internal Revenue Code  
Section 6015****SUMMARY**

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.<sup>1</sup> Joint and several liability permits the IRS to collect the entire amount due from either taxpayer.<sup>2</sup>

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 that were issued between June 1, 2010, and May 31, 2011, as well as one decision, *Jones v. Commissioner*,<sup>3</sup> issued on June 13, 2011. As we found last year, the most significant issue the courts addressed this year is the period of time within which a taxpayer may 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 under IRC § 6015(f) was resolved when the IRS announced that the regulation will be revised to remove the two-year time limit.<sup>4</sup> The Tax Court also explored the difference between a *de novo* scope and standard of review and a review for abuse of discretion limited to the administrative record,<sup>5</sup> and a Court of Appeals discussed the effect of a final notice of determination that was returned as undeliverable.<sup>6</sup>

**PRESENT LAW****Traditional Innocent Spouse Relief Under IRC § 6015(b)**

IRC § 6015(b) provides that a requesting spouse shall be partially or fully relieved from joint and several liability, pursuant to procedures established by the Secretary, if the requesting spouse can demonstrate that:

<sup>1</sup> IRC § 6013(d)(3). We use the terms “deficiency” and “understatement” interchangeably for purposes of this discussion and the case table in Appendix III, even though IRC § 6015(b)(1)(D) and IRC § 6015(f) expressly use the term “deficiency” and IRC § 6015(b)(1)(B) refers to an “understatement of tax.”

<sup>2</sup> The National Taxpayer Advocate, in the 2005 Annual Report to Congress, proposed legislation that would eliminate joint and several liability for joint filers. See National Taxpayer Advocate 2005 Annual Report to Congress 407.

<sup>3</sup> *Jones v. Comm’r*, 642 F.3d 459 (4th Cir., 2011), *rev’g and remanding* T.C. Docket No. 17359-08 (2009).

<sup>4</sup> IR 2011-80 (July 25, 2011), *available at* <http://www.irs.gov/newsroom/article/0,,id=242867,00.html>. Details of the changes in the rule are provided by IRS Notice 2011-70 (July 25, 2011), *available at* <http://www.irs.gov/pub/irs-drop/n-11-70.pdf>.

<sup>5</sup> *Wilson v. Comm’r*, T.C. Memo. 2010-134, *appeal docketed*, No. 10-72754 (9th Cir. Sept. 10, 2010).

<sup>6</sup> *Terrell v. Comm’r*, 625 F.3d 254 (5th Cir. 2011), *rev’g and remanding* Tax Court Docket No. 15894-07 (July 30, 2009).

1. A joint return was filed;
2. There was an understatement of tax attributable to erroneous items of the nonrequesting spouse;<sup>7</sup>
3. Upon signing the return, the requesting spouse did not know or have reason to know of the understatement;
4. Taking into account all the facts and circumstances, it is inequitable to hold the requesting spouse liable; and
5. The requesting spouse elected relief within two years after the IRS began collection activities against him or her.<sup>8</sup>

#### Allocation of Liability Under IRC § 6015(c)

IRC § 6015(c) provides that the requesting spouse shall be relieved from liability for deficiencies allocable to the nonrequesting spouse, pursuant to procedures established by the Secretary. To obtain relief under this section, the requesting spouse must demonstrate that:

1. A joint return was filed;
2. At the time relief was elected, the joint filers were unmarried, legally separated, widowed, or had not lived in the same household for the 12 months immediately preceding the election; and
3. The election was made within two years after the IRS began collection activities with respect to the requesting spouse.

This election allocates to each joint filer the portion of the deficiency attributable to each filer as calculated under the allocation provisions of IRC § 6015(d). A taxpayer is ineligible to make an election under IRC § 6015(c) if the IRS demonstrates that, at the time he or she signed the return, the requesting taxpayer had “actual knowledge” of any item giving rise to the deficiency.<sup>9</sup> Relief is not available for amounts attributable to fraud, fraudulent schemes, or certain transfers of disqualified assets.<sup>10</sup> Finally, no credit or refund is allowed as a result of relief granted under IRC § 6015(c).<sup>11</sup>

<sup>7</sup> An erroneous item is any income, deduction, credit, or basis that is omitted from or incorrectly reported on the joint return. See Treas. Reg. § 1.6015-1(h)(4).

<sup>8</sup> Not all actions that involve collection will trigger the two-year limitations period. Under the regulations, only the following four events constitute “collection activity” that will start the two-year period: (1) an IRC § 6330 notice; (2) an offset of an overpayment of the requesting spouse against the joint income tax liability under IRC § 6402; (3) the filing of a suit by the United States against the requesting spouse for the collection of the joint tax liability; and (4) the filing of a claim by the United States to collect the joint tax liability in a court proceeding in which the requesting spouse is a party or which involves property of the requesting spouse. Treas. Reg. § 1.6015-5(b)(2).

<sup>9</sup> IRC § 6015(c)(3)(C).

<sup>10</sup> IRC §§ 6015(c)(4), (d)(3)(C).

<sup>11</sup> IRC § 6015(g)(3).

**Equitable Relief Under IRC § 6015(f)**

IRC § 6015(f) provides that the Secretary may relieve a taxpayer from liability for both deficiencies and underpayments<sup>12</sup> where the taxpayer demonstrates that:

1. Relief under IRC § 6015(b) or (c) is unavailable; and
2. Taking into account all the facts and circumstances, it would be inequitable to hold the taxpayer liable for the underpayment or deficiency.

Prior to July 25, 2011, the IRS applied one of the regulations under IRC § 6015(f) which requires the taxpayer to request equitable relief within two years after the IRS initiates collection activity with respect to the taxpayer.<sup>13</sup> As discussed in last year's report, the United States Court of Appeals for the Seventh Circuit reversed the Tax Court's holding that the regulation was invalid, and held that the two-year rule is a valid interpretation of IRC § 6015(f).<sup>14</sup> This year, two additional Courts of Appeals, in separate cases, reversed the Tax Court's holding that the regulation was invalid.<sup>15</sup> Several other cases were pending in other Courts of Appeal.<sup>16</sup>

On July 25, 2011, the IRS announced that notwithstanding the appellate court decisions that upheld the validity of the regulation, the regulations issued under IRC § 6015 should be revised to remove the two-year rule for requests for equitable relief.<sup>17</sup> Pending modification of the regulation to formally remove the two-year rule, taxpayers requesting equitable relief under IRC § 6015(f) after July 25, 2011, may do so without regard to when the first collection activity was taken. Requests must be filed within the period of limitation on collection in IRC § 6502<sup>18</sup> or, for any credit or refund of tax, within the period of limitation in IRC § 6511.<sup>19</sup> Motions for voluntary dismissal were filed on July 25, 2011, in cases pending in the various appellate courts.

<sup>12</sup> An underpayment of tax occurs when the tax is properly shown on the return but is not paid. *Washington v. Comm'r*, 120 T.C. 137, 158-159 (2003).

<sup>13</sup> Treas. Reg. §1.6015-5(b)(1).

<sup>14</sup> *Lantz v. Comm'r*, 607 F.3d 479 (7th Cir. 2010), *rev'g and remanding* 132 T.C. 131 (2009).

<sup>15</sup> *Mannella v. Comm'r*, 631 F.3d 115 (3d Cir. 2011); *Jones v. Comm'r*, 642 F.3d 459 (4th Cir. 2011).

<sup>16</sup> *Hall v. Comm'r*, 135 T.C. 374, *appeal docketed*, No. 10-2628 (6th Cir. Dec. 14, 2010); *Buckner v. Comm'r*, T.C. Docket No. 12153-09, *appeal docketed*, No. 10-2056 (6th Cir. Aug. 18, 2010); *Payne v. Comm'r*, T.C. Docket No. 10768-09, *appeal docketed*, No. 10-72855 (9th Cir. Sept. 17, 2010); *Coulter v. Comm'r*, T.C. Docket No. 1003-09, *appeal docketed*, No. 10-680 (2d Cir. Feb. 24, 2010).

<sup>17</sup> IR 2011-80 (July 25, 2011), *available at* <http://www.irs.gov/newsroom/article/0,,id=242867,00.html>. Details of the changes to the rule are provided in IRS Notice 2011-70 (July 25, 2011), *available at* <http://www.irs.gov/pub/irs-drop/n-11-70.pdf>. The notice provides transitional rules, and provides that pending litigation will be managed consistently with the removal of the two-year rule.

<sup>18</sup> The statutory period of limitations on collection is generally ten years after the date the tax is assessed. IRC § 6502(a). However, if a court proceeding to collect the tax is brought, such as a suit to reduce a tax liability to judgment, the period of limitations on collection is extended. Therefore, the period of limitations on collection could exceed ten years and a claim for innocent spouse relief would be valid at any point during that time.

<sup>19</sup> Generally, taxpayers must request a refund within three years from the date their return was filed, or two years from the time the tax was paid, whichever occurs later, or, if no return was filed, within two years from the time the tax was paid. IRC § 6511(a). If taxpayers meet the three-year requirement, they can recover payments made during the three-year period that precedes the date of the refund request, plus the period of any extension of time for filing the return. However, taxpayers who do not meet the three-year requirement can recover only payments made during the two-year period preceding the date of the refund request. IRC § 6511(b)(2).

Revenue Procedure 2003-61 lists some of the factors the IRS considers in determining whether equitable relief is appropriate.<sup>20</sup> These factors include marital status, economic hardship, knowledge or reason to know, legal obligations of the nonrequesting spouse, significant benefit to the requesting spouse, compliance with income tax laws, and abuse.

### Rights of Nonrequesting Spouse

The individual with whom the requesting spouse filed the joint return is generally referred to as a “nonrequesting spouse,” and is granted certain rights by IRC § 6015. The nonrequesting spouse must be notified and given an opportunity to participate in any administrative proceedings concerning a claim under IRC § 6015.<sup>21</sup> Further, if during the administrative process full or partial relief is granted to the requesting spouse, the nonrequesting spouse can file a protest and receive an administrative conference in the IRS Appeals function.<sup>22</sup> The nonrequesting spouse does not have the right to petition the Tax Court in response to the IRS’s administrative determination regarding IRC § 6015 relief.<sup>23</sup> If the requesting spouse files a Tax Court petition, the nonrequesting spouse must receive notice of the Tax Court proceeding and has an unconditional right to intervene in the proceeding to dispute or support the requesting spouse’s claim for relief.<sup>24</sup> However, an intervening spouse has no standing to appeal the Tax Court’s decision to the United States Court of Appeals.<sup>25</sup>

### Judicial Review

Taxpayers seeking relief under IRC § 6015 generally file Form 8857, *Request for Innocent Spouse Relief*.<sup>26</sup> After reviewing the request, the IRS issues a final notice of determination granting or denying relief in whole or in part. The taxpayer has 90 days from the date the IRS mails the notice to file a petition with the Tax Court.<sup>27</sup> The Tax Relief and Health Care Act of 2006 amended IRC § 6015(e) to expressly provide that the Tax Court has jurisdiction in stand-alone cases to review IRC § 6015(f) determinations, even where no deficiency has been asserted.<sup>28</sup>

<sup>20</sup> Rev. Proc. 2003-61, 2003-2 C.B. 296.

<sup>21</sup> IRC § 6015(h)(2).

<sup>22</sup> Rev. Proc. 2003-19, 2003-5 C.B. 371.

<sup>23</sup> IRC § 7442; *Maier v. Comm’r*, 119 T.C. 267 (2002), *aff’d* by 360 F.3d 361 (2d Cir. 2004) (holding that there are no provisions in IRC § 6015 that allow the nonrequesting spouse to petition the Tax Court from a notice of determination).

<sup>24</sup> *Van Arsdalen v. Comm’r*, 123 T.C. 135 (2004).

<sup>25</sup> *Baranowicz v. Comm’r*, 432 F.3d 972 (9th Cir. 2005).

<sup>26</sup> See IRS Form 8857, *Request for Innocent Spouse Relief*, Instructions (Sept. 2010).

<sup>27</sup> IRC § 6015(e)(1)(A)(ii).

<sup>28</sup> Pub. L. No. 109-432, Div. C, § 408(a), (c), 120 Stat. 2922, 3061-62 (2006). The filing of a Tax Court petition in response to the final notice of determination or after the IRC § 6015 claim is pending for six months is often referred to as a “stand-alone” proceeding, because jurisdiction is predicated on IRC § 6015(e) and not deficiency jurisdiction under IRC § 6213.

## ANALYSIS OF LITIGATED CASES

We analyzed 43 opinions issued between June 1, 2010, and May 31, 2011, including 38 cases in the Tax Court, one each in the United States Courts of Appeals for the Third and Fifth Circuits, two in the Court of Appeals for the Ninth Circuit, and one in a U.S. District Court. In addition, we analyzed one opinion issued on June 13, 2011, by the United States Court of Appeals for the Fourth Circuit. Fifty-five percent of the cases (24 of 44) were decided in favor of the IRS, 30 percent (13 of 44) in favor of the taxpayer (including one case in which only the intervenor opposed granting relief), and 16 percent (seven of 44) ended in split decisions.<sup>29</sup> In 52 percent (23 of 44) of the cases, the taxpayers were *pro se* (i.e., they represented themselves). Taxpayers prevailed in 26 percent (six of 23) of the cases in which they proceeded *pro se*; four other *pro se* taxpayers obtained split decisions. The nonrequesting spouse intervened in 18 percent of the cases (eight of 44).

Seventy-seven percent of the cases (34 of 44) involved an analysis of whether to grant relief. Thirty-four percent of the cases (15 of 44) involved procedural issues,<sup>30</sup> with 67 percent (ten of 15) of these cases decided in favor of the IRS, and 33 percent (five of 15) in favor of the taxpayer.

Of the 34 cases decided on the merits, 47 percent (16 of 34) were decided in favor of the IRS, 32 percent (11 of 34) in favor of the taxpayer, and in 21 percent (seven cases) the court split its decision. See Table 8 in Appendix III for a detailed breakdown of the cases.<sup>31</sup>

### Procedural Issues

The most significant procedural issue courts addressed is the validity of a Treasury regulation that requires a taxpayer to request relief under IRC § 6015(f) within two years after the IRS commences collection activity. Additionally, the Tax Court explored the difference between a *de novo* scope and standard of review and a review for abuse of discretion limited to the administrative record, and a Court of Appeals discussed the effect of a notice of determination that was returned as undeliverable.

### *Mannella v. Commissioner and Jones v. Commissioner*

As reported last year, in *Lantz v. Commissioner*<sup>32</sup> the Tax Court considered the validity of Treasury Regulation §1.6015-5(b)(1), which requires the requesting spouse to make an election for relief under IRC § 6015(f) within two years after the IRS initiates collection activity against the requesting spouse. The court held that the regulation was not entitled to

<sup>29</sup> These percentages add up to more than 100 due to rounding.

<sup>30</sup> The percentages add up to more than 100 and the number of cases adds up to more than 44 because five cases addressed the procedural issue of the validity of the two-year rule in Treas. Reg. § 1.6015-5(b)(1) and also contained an analysis of whether to grant relief on the merits.

<sup>31</sup> Table 8 in Appendix III also includes *Lantz v. Comm'r*, 607 F.3d 479 (7th Cir. 2010), *rev'g and remanding* 132 T.C. 131 (2009), which we discussed in last year's report and do not discuss this year. We include the *Lantz* case in the table for the sake of completeness, as it was the first case in which the Tax Court held invalid the two-year rule in Treas. Reg. 1.6015-5(b)(1).

<sup>32</sup> *Lantz v. Comm'r*, 132 T.C. 131 (2009), *rev'd and remanded by* 607 F.3d 479 (7th Cir. 2010).

judicial deference because it failed the test articulated by the Supreme Court in *Chevron*.<sup>33</sup> Shortly after the *Lantz* decision, the Tax Court decided *Mannella v. Commissioner*,<sup>34</sup> in which it again held that the regulation containing the two-year rule was invalid. The IRS appealed both Tax Court decisions to the United States Courts of Appeals for the Seventh and Third Circuits, respectively. As we reported last year, the Court of Appeals for the Seventh Circuit reversed the Tax Court's decision in *Lantz* and remanded the case to the Tax Court.

After the Seventh Circuit's reversal in the *Lantz* case, the Tax Court adhered to the rule in *Golsen v. Commissioner*<sup>35</sup> that it will defer to a Court of Appeals decision that is squarely on point where an appeal from the Tax Court decision lies to that Court of Appeals. The Tax Court continued to hold the regulation invalid in cases appealable to other courts, and the IRS appealed some of those decisions.<sup>36</sup> This year, the Court of Appeals for the Third Circuit reversed and remanded the *Mannella* case to the Tax Court with instructions to consider whether the doctrine of equitable tolling would operate to suspend the two-year period.<sup>37</sup> The Court of Appeals for the Fourth Circuit also reversed the Tax Court on the same issue this year in *Jones v. Commissioner*, and remanded the case for the Tax Court to consider whether an extension of time to request relief might be available pursuant to a different Treasury regulation.<sup>38</sup>

As described above, on July 25, 2011, the IRS announced that the Treasury regulations under IRC § 6015 would be revised to remove the two-year rule for claims for equitable relief, and moved to dismiss affected cases pending in appellate courts. On October 20, 2011, the IRS notified the Tax Court that the parties had reached a settlement in the *Jones* case and were preparing a stipulated decision.<sup>39</sup> Pursuant to agreement of the parties, the Tax Court on August 30, 2011, entered a decision in the *Mannella* case that no income tax was due after the application of IRC § 6015(f).<sup>40</sup>

<sup>33</sup> *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984).

<sup>34</sup> 132 T.C. 196 (2009).

<sup>35</sup> 54 T.C. 742, 757 (1970), *aff'd* by 445 F.2d 985 (10th Cir. 1971).

<sup>36</sup> See, e.g., *Young v. Comm'r*, T.C. Docket No. 12718-09 (May 12, 2011); *Pullins v. Comm'r*, 136 T.C. No. 20 (2011); *Stephenson v. Comm'r*, T.C. Memo. 2011-16 (2011); *Hall v. Comm'r*, 135 T.C. 374, *appeal docketed*, No. 10-2628 (6th Cir. Dec. 14, 2010); *Buckner v. Comm'r*, T.C. Docket No. 12153-09, *appeal docketed*, No. 10-2056 (6th Cir. Aug. 18, 2010); *Carlile v. Comm'r*, T.C. Docket No. 11567-09; *Payne v. Comm'r*, T.C. Docket No. 10768-09, *appeal docketed*, No. 10-72855 (9th Cir. Sept. 17, 2010); *Coulter v. Comm'r*, T.C. Docket No. 1003-09, *appeal docketed*, No. 10-680 (2d Cir. Feb. 24, 2010). However, where a district court, prior to the Tax Court's decision in *Lantz*, held that the two-year rule precluded relief, the doctrine of *res judicata* prevented the taxpayer from raising the claim in Tax Court post-*Lantz*. *Haag v. Comm'r*, T.C. Memo. 2011-87; IRC § 6015(g). Additionally, the IRS prevailed in two cases in which the Tax Court disregarded the two-year rule. *Bland v. Comm'r*, T.C. Memo. 2011-8; *Kelly v. Comm'r*, T.C. Memo. 2010-267.

<sup>37</sup> *Mannella v. Comm'r*, 631 F.3d 115, 125-126 (3d Cir. 2011) *rev'g and remanding* 132 T.C. 196 (2009). Citing its own precedent, the court noted: "there may be equitable tolling '(1) where the defendant has actively misled the plaintiff respecting the plaintiff's cause of action; (2) where the plaintiff in some extraordinary way has been prevented from asserting his or her rights; or (3) where the plaintiff has timely asserted his or her rights mistakenly in the wrong forum.'"

<sup>38</sup> *Jones v. Comm'r*, 642 F.3d 459 (4th Cir. 2011), *rev'g and remanding* T.C. Docket No. 17359-08 (2009). Treas. Reg. § 301.9100-3 permits the IRS to grant an extension of time to a taxpayer for "regulatory elections . . . when the taxpayer provides the evidence . . . to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the Government."

<sup>39</sup> See *Jones v. Comm'r*, *order*, T.C. Docket No. 17359-08 (Oct. 25, 2011).

<sup>40</sup> *Mannella v. Comm'r*, *decision entered*, T.C. Docket No. 17531-07 (Aug. 30, 2011).

*Wilson v. Commissioner*

In *Wilson v. Commissioner*,<sup>41</sup> Mr. Wilson, an insurance salesman, generated additional income by steering people into a Ponzi scheme. Mrs. Wilson was aware of the additional income but believed it derived from legitimate business operations. The additional income, which arose in 1997-1999, was not reported on the joint returns the couple filed for 1997 or 1998. The couple later filed amended 1997 and 1998 returns that reported the income, and included the additional income on their 1999 joint return. The resulting \$540,000 tax debt from the returns for the three years remained unpaid. In 2002, Mrs. Wilson requested innocent spouse relief under IRC § 6015(f) in a stand-alone petition.<sup>42</sup>

In the Tax Court proceeding, pursuant to *Porter v. Commissioner (Porter I)*,<sup>43</sup> the Tax Court's scope of review was *de novo*, which means that the court could and did consider evidence introduced at trial that was not part of the administrative record.<sup>44</sup> The Court of Appeals for the 11th Circuit has held that *de novo* review is appropriate for Tax Court review of stand-alone claims under IRC § 6015(f).<sup>45</sup> However, the IRS does not agree with the decision in *Porter I*, and has instructed Chief Counsel attorneys to, among other things, continue to raise the scope of review argument whenever appropriate.<sup>46</sup> Pursuant to its decision in *Porter v. Commissioner (Porter II)*,<sup>47</sup> the Tax Court used the *de novo* standard of review, rather than an abuse of discretion standard of review. Under a *de novo* standard, the court considers the facts of the case anew and determines whether it is inequitable to hold the requesting spouse liable for the unpaid tax or deficiency. 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, and the requesting spouse bears the burden of proving that the Commissioner abused his discretion in denying relief.<sup>48</sup> The IRS also does not agree with the decision in *Porter II*, and has

<sup>41</sup> T.C. Memo. 2010-134, *appeal docketed*, No.10-72754 (9th Cir. Sept. 10, 2010).

<sup>42</sup> The trial began in 2005, but the Tax Court suspended the case due to the questioned jurisdiction of the Tax Court over stand-alone innocent spouse cases. See *Comm'r v. Ewing*, 439 F.3d 1009 (9th Cir. 2006), *rev'g* 118 T.C. 494 (2002) and vacating 122 T.C. 32 (2004). As discussed *supra*, the Tax Relief and Health Care Act of 2006 amended IRC § 6015(e) to expressly provide that the Tax Court has jurisdiction in stand-alone cases to review IRC § 6015(f) determinations, permitting Mrs. Wilson's case to go forward.

<sup>43</sup> 130 T.C. 115 (2008) (*Porter I*). In *Porter I*, the Tax Court denied the IRS's motion *in limine* (*i.e.*, as a preliminary matter), which sought to preclude the taxpayer from offering evidence not already contained in the administrative record.

<sup>44</sup> The Tax Court's decision in *Porter I* was in turn based on its earlier holding in *Ewing v. Comm'r*, 118 T.C. 494 (2002), vacated on other grounds *sub nom. Comm'r v. Ewing*, 439 F.3d 1009 (9th Cir. 2006), in which the Tax Court found that the Administrative Procedure Act, 5 U.S.C. §§ 551-559, 701-706 (2000), which limits the scope of judicial review to the administrative record, was not applicable to Tax Court proceedings, including IRC § 6015 proceedings. Further, the Tax Court found that the use of the word "determine" in IRC § 6015 is similar to the use of the word "redetermination" in IRC § 6213(a) under which it is unquestioned that the court conducts trials *de novo*. The Tax Court concluded that the use of this term meant that Congress intended the court to have *de novo* review authority for IRC § 6015 cases.

<sup>45</sup> *Neal v. Comm'r*, 557 F.3d 1262 (11th Cir. 2009), *aff'g* T.C. Memo. 2005-201.

<sup>46</sup> Notice CC-2009-021 (June 30, 2009).

<sup>47</sup> 132 T.C. No 11 (2009); *Porter II* is a continuation of the same case that produced the 2008 holding (*Porter I*, see *supra* note 43) that Tax Court review of denials of relief under IRC § 6015(f) is not limited to the administrative record.

<sup>48</sup> *Jonson v. Comm'r*, 118 T.C. 106, 125, *aff'd by* 353 F.3d 1181 (10th Cir. 2003).

instructed Chief Counsel attorneys to, among other things, continue to raise the standard of review argument whenever appropriate.<sup>49</sup>

The Tax Court articulated the ways in which its conclusions, based on *de novo* review, differed from the IRS's conclusions that were based solely on the administrative record. First, the court considered Mrs. Wilson's marital status. Pursuant to Revenue Procedure 2000-15,<sup>50</sup> if a requesting spouse is "separated (whether legally separated or living apart) or divorced," this factor favors granting relief, while if the requesting spouse is still married to the other joint filer the factor is neutral. Mrs. Wilson requested innocent spouse relief in 2002. Her responses to IRS inquiries during the period the IRS was considering her claim showed that she was still married to Mr. Wilson, so the IRS treated this factor as neutral. However, the Wilsons divorced in 2007. The Tax Court, considering Mrs. Wilson's marital status at the time of trial in 2008, therefore found the marital status factor weighed in favor of relief. Similarly, the administrative record showed that Mrs. Wilson had made a good faith effort to comply with federal income tax laws in 2001 and 2002, the years following those to which the request for relief related, so, pursuant to Revenue Procedure 2000-15 the IRS treated this factor as neutral. The Tax Court, however, considering Mrs. Wilson's failure to adduce testimony or evidence at trial as to her compliance in 2003 and 2004, found this factor slightly weighed against relief.

Another area of divergence was the evaluation of the requesting spouse's knowledge or reason to know. According to Revenue Procedure 2000-15, if the requesting spouse knew or had reason to know the reported liability would be unpaid at the time the return was signed, this factor weighs against granting relief. The IRS wrote to Mrs. Wilson, asking her to explain what she knew when she signed the returns, but Mrs. Wilson did not respond. During administrative proceedings, she did not otherwise show that she did not know or have reason to know the liability would not be paid. The IRS therefore treated this factor as weighing against relief. The Tax Court, however, reasoned that the amounts of tax shown on the original returns for 1997 and 1998 (*i.e.*, without taking into the additional tax attributable to Mr. Wilson's fraudulent business activity) were such that, in view of Mr. Wilson's earnings and the couple's assets, Mrs. Wilson reasonably believed Mr. Wilson would pay them. The situation for the 1999 return was slightly different, because that return included the additional tax attributable to the fraudulent activity, but the Tax Court found that Mrs. Wilson still reasonably believed that family assets would be sufficient to pay the tax. The same was true of the amended returns for 1997 and 1998, which Mrs. Wilson signed on the same date as the original return for 1999; even though the amended returns showed substantially greater amounts of taxes due than the original returns, Mrs. Wilson lacked reason to know that Mr. Wilson would fail to pay them. Therefore, the Tax Court found that the knowledge factor weighed in favor of relief.

<sup>49</sup> Notice CC-2009-021 (June 30, 2009).

<sup>50</sup> Rev. Proc. 2000-15, 2000-1 C.B. 447, was in effect when Mrs. Wilson filed her request for innocent spouse relief. It has been superseded by Rev. Proc. 2003-61, 2003-2 C.B. 296, discussed *supra*, which generally applies to requests for relief filed on or after Nov. 1, 2003.

The Tax Court also arrived at a different conclusion than the IRS with respect to the hardship factor. According to Revenue Procedure, 2000-15, if satisfaction of the tax liability would cause the requesting spouse to be unable to pay her reasonable basic living expenses, this factor weighs in favor of relief. Mrs. Wilson provided records to the IRS during the administrative proceedings showing that her monthly income exceeded her expenses by only a small amount, but she failed to substantiate her expenses as requested and the IRS therefore concluded that she would not suffer economic hardship. The Tax Court, however, considered Mrs. Wilson's credible testimony, her modest living arrangements at the time of trial, and other expenses not included in the administrative record, and concluded that the hardship factor weighed in favor of relief.

Finally, the Tax Court evaluated the question of attribution of the liability differently from the IRS. Under Revenue Procedure 2000-15, if the tax liability is solely attributable to the nonrequesting spouse, the factor weighs in favor of granting relief, and if the liability is attributable to requesting spouse, the factor weighs against granting relief.<sup>51</sup> Because Mrs. Wilson provided basic clerical work for Mr. Wilson and was an employee of his company, and there was little information in the administrative record pertaining to attribution of the tax liability, the IRS assumed that 50 percent of the tax liability was attributable to Mrs. Wilson. The factor therefore weighed against granting relief. The Tax Court instead found that based on the trial record, Mrs. Wilson had no understanding of Mr. Wilson's business and merely assisted her husband, who made all the business decisions. The court concluded that the tax liability was entirely attributable to Mr. Wilson, so this factor weighed in favor of relief.

Taking into account all the facts and circumstances, and after weighing the various factors, the Tax Court held that Mrs. Wilson was entitled to relief. The IRS has appealed the Tax Court's decision to the Court of Appeals for the Ninth Circuit.

### *Terrell v. Commissioner*

In *Terrell v. Commissioner*,<sup>52</sup> Mrs. Terrell requested innocent spouse relief by filing Form 8857, and shortly thereafter moved to an address different from the one shown on the form. Using the address on the Form 8857, the IRS mailed Mrs. Terrell a letter confirming receipt of the form, as well as two preliminary notices of determination denying relief. All of this correspondence was returned to the IRS as undeliverable by February 28, 2007. Hearing nothing from Mrs. Terrell, the IRS on April 6, 2007, mailed a final notice of determination denying relief, again using the old address on the Form 8857. The final notice of determination, which informed Mrs. Terrell that she had 90 days to petition the Tax Court for review, was returned to the IRS as undeliverable on May 7, 2011. In the meantime (between the time the IRS mailed the final notice and the time it was returned), on April

<sup>51</sup> The current Rev. Proc. 2003-61 does not include attribution among the factors to be considered in determining whether to grant relief, but generally requires that the liability be attributable to the nonrequesting spouse as a threshold condition for obtaining relief. See Rev. Proc. 2003-61 sec. 4.01(7).

<sup>52</sup> 625 F.3d 254 (5th Cir. 2011), *rev'g and remanding* Tax Court Docket No. 15894-07 (July 30, 2009).

11, 2007, Mrs. Terrell filed her 2006 return using her new address. When the IRS received the returned final notice of determination, it searched its databases, discovered the new address, and on May 14, 2007, re-sent the final notice of determination to that address. Mrs. Terrell filed her Tax Court petition on July 13, 2007.

The IRS contended that the 90-day period for petitioning the Tax Court began to run on April 6, 2007, the date the final notice of determination was sent the first time. Because Mrs. Terrell did not file her Tax Court petition within 90 days of that date, the IRS moved to dismiss the case for lack of jurisdiction. Mrs. Terrell contended that the 90-day period commenced on May 14, 2007, when the final notice of determination was sent the second time, and because she filed her Tax Court petition within 90 days of May 14, her petition was timely. The Tax Court agreed with the IRS and, holding that it lacked jurisdiction because there was no timely petition, dismissed the case.

Whether the first notice of determination operated to commence the 90-day period depends on whether it was mailed to Mrs. Terrell's last known address, as required by IRC § 6015(e). The Court of Appeals for the Fifth Circuit, analogizing cases under IRC §§ 6012 and 6013 that deal with the timeliness of Tax Court petitions filed in response to a notice of deficiency, relied on its own precedent<sup>53</sup> and held that the IRS is entitled to consider the address on the taxpayer's most recently filed return as the last known address. However, the IRS must also use reasonable diligence to determine the taxpayer's address in light of all relevant circumstances. Reasonable diligence requires further investigation where the IRS knows at the time of mailing that the address on file may no longer be valid because previous letters have been returned.

The Court of Appeals for the Fifth Circuit held that when the IRS sent the notice of determination the first time, three pieces of correspondence sent to Mrs. Terrell at that address had already been returned as undeliverable. Because the IRS did nothing to ascertain the correct address at that point, it did not exercise reasonable diligence, and the notice of determination was not sent to Mrs. Terrell's last known address the first time. Because the notice of determination that was sent the first time did not actually reach Mrs. Terrell, the "no prejudice" rule adopted by other Courts of Appeal did not apply.<sup>54</sup> The notice of determination was null and void the first time it was sent. However, it was legally effective to commence the 90-day period for petitioning the Tax Court the second time it was sent. Because Mrs. Terrell filed her petition within the statutory period, the Tax Court had jurisdiction to hear her claim. The Court of Appeals reversed and remanded the case to the Tax Court.

<sup>53</sup> *Pomeroy v. U.S.*, 864 F.2d 1191 (5th Cir. 1989); *Mulder v. Comm'r*, 855 F.2d 208 (5th Cir. 1988).

<sup>54</sup> Under the "no prejudice" rule, the IRS satisfies the statutory notice requirement if the taxpayer actually receives the notice without delay prejudicial to his or her ability to petition the Tax Court, even though the IRS failed to mail the notice to the taxpayer's last known address.

### Relief on the Merits

While the courts considered many factors in determining the appropriateness of relief on the merits under IRC § 6015, the most significant factor was whether the requesting taxpayer had actual or constructive knowledge of the tax deficiency or that the nonrequesting spouse would not pay the tax. All three avenues for relief contain a knowledge element or factor, making it the linchpin in most of the courts' analyses.<sup>55</sup> Actual or constructive knowledge was a factor in 32 of the 34 decisions on the merits. These cases suggest that determining what a taxpayer knew or should have known will continue to generate a significant amount of controversy as long as joint filers are taxed on their combined incomes and remain jointly and severally liable for the tax required to be shown on the return.

Another significant factor the Tax Court considered was spousal abuse, which was a factor in nine of the 34 decisions on the merits. The Tax Court found spousal abuse weighed in favor of granting relief under IRC § 6015(f) in five cases, and granted full or partial relief in all of them. This suggests that taxpayers who are victims of domestic abuse are likely to be entitled to equitable relief when all the facts and circumstances are taken into account.

### CONCLUSION

This year, the courts continued to address the procedural issue of whether the Treasury regulation that imposes a two-year time period within which a requesting spouse must elect relief under IRC § 6015(f) was invalid. Three Courts of Appeal ultimately held that the regulation was valid, and the issue was pending in other appellate courts. On July 25, 2011, the IRS announced that it was eliminating the two-year rule for requests for relief under IRC § 6015(f). Another procedural issue the Tax Court explored is its *de novo* standard and scope of review. With respect to determinations on the merits, issues concerning the requesting spouse's knowledge continued to predominate. The issue of domestic abuse as a factor in determining whether to grant equitable relief was also frequent, with the taxpayer prevailing in whole or in part whenever that factor weighed in favor of granting relief.

<sup>55</sup> See IRC § 6015(b)(1)(C); § 6015(c)(3)(C); Rev. Proc. 2003-61, 2003-2 C.B. 296 §§ 4.02(1)(b) and 4.03(2)(a)(iii).

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

From June 1, 2010, through May 31, 2011, the federal courts issued decisions in at least 43 cases involving the Internal Revenue Code (IRC) § 6673 “frivolous issues” penalty, and at least one case involving an analogous penalty at the appellate level. These penalties are imposed against taxpayers for maintaining a case primarily for delay, raising frivolous arguments, unreasonably failing to pursue administrative remedies, or filing a frivolous appeal.<sup>1</sup> In many of the cases we reviewed, taxpayers escaped liability for the penalty but were warned they could face sanctions for similar conduct in the future.<sup>2</sup> Nonetheless, we included these cases in our analysis to illustrate what conduct will and will not be tolerated by the courts.

**PRESENT LAW**

The U.S. Tax Court is authorized to impose a penalty against a taxpayer if the taxpayer institutes or maintains a proceeding primarily for delay, takes a frivolous position in a proceeding, or unreasonably fails to pursue available administrative remedies.<sup>3</sup> The maximum penalty is \$25,000.<sup>4</sup> In some cases, the IRS requests that the Tax Court impose the penalty;<sup>5</sup> in other cases, the Tax Court exercises its discretion, *sua sponte*,<sup>6</sup> to do so.

Taxpayers who institute an action pursuant to IRC § 7433<sup>7</sup> in a United States District Court for damages against the United States could be subject to a maximum penalty of \$10,000 if the court determines the taxpayer’s position in the proceedings is frivolous or groundless.<sup>8</sup>

<sup>1</sup> The Tax Court generally imposes the penalty under IRC § 6673(a)(1). Other courts may impose the penalty under IRC § 6673(b)(1). U.S. Courts of Appeals generally impose sanctions under IRC § 7482(c)(4), 28 U.S.C. § 1927, or Rule 38 of the Federal Rules of Appellate Procedure, although some appellate-level penalties may be imposed under other authorities.

<sup>2</sup> See, e.g., *Forrest v. Comm’r*, T.C. Memo. 2010-263.

<sup>3</sup> IRC §§ 6673(a)(1)(A), (B), and (C).

<sup>4</sup> IRC § 6673(a)(1).

<sup>5</sup> The standards for the IRS’s decision to seek sanctions under IRC § 6673(a)(1) are found in the Chief Counsel Directives Manual (CCDM). See CCDM 35.10.2 (Aug. 11, 2004). For sanctions of opposing parties, under IRC § 6673(a)(2), all requests for sanctions are reviewed by the designated agency sanctions officer under Executive Order 12988 on Civil Justice Reform. This review ensures uniformity on a national basis. See, e.g., CCDM 35.10.2.2.3 (Aug. 11, 2004).

<sup>6</sup> “*Sua sponte*” means without prompting or suggestion; on its own motion. *Black’s Law Dictionary* (9th ed. 2009). Thus, for conduct that it finds particularly offensive, the Tax Court can choose to impose a penalty under IRC § 6673 even if the IRS has not requested the penalty. See, e.g., *Hyde v. Comm’r*, T.C. Memo. 2011-104.

<sup>7</sup> IRC § 7433(a) allows taxpayers a civil cause of action against the United States if an IRS employee intentionally or recklessly disregards any IRC provision or regulation promulgated under the IRC.

<sup>8</sup> IRC § 6673(b)(1).

In addition, IRC § 7482(c)(4),<sup>9</sup> §§ 1912 and 1927 of Title 28 of the U.S. Code,<sup>10</sup> and Rule 38 of the Federal Rules of Appellate Procedure<sup>11</sup> (among other laws and rules of procedure) authorize federal courts to impose penalties against taxpayers or attorneys for raising frivolous arguments or using litigation tactics primarily to delay the collection process. Because the sources of authority for imposing appellate-level sanctions are numerous and some of these sanctions may be imposed in non-tax cases, this report focuses primarily on the IRC § 6673 penalty. However, Table 9 in Appendix III lists one tax case in which a Court of Appeals imposed sanctions under other authorities.<sup>12</sup>

### ANALYSIS OF LITIGATED CASES

We analyzed 43 opinions issued between June 1, 2010, and May 31, 2011, that addressed the IRC § 6673 penalty. Thirty-six of these opinions were issued by the Tax Court and seven were issued by U.S. Courts of Appeals in cases brought by taxpayers who sought review of the Tax Court's imposition of the penalty. Notably, the Courts of Appeals sustained the Tax Court's position in all seven cases.

In 18 cases, the Court imposed penalties under IRC § 6673, with the amounts ranging from \$500 to the maximum of \$25,000. We reviewed seven cases where taxpayers prevailed when the IRS asked the court to impose a penalty. In five of these cases the court warned the taxpayers not to bring similar arguments in the future.<sup>13</sup> In the remaining two cases where the taxpayer prevailed when the IRS sought imposition of the penalty, the court found that the taxpayers' behaviors did not rise to the level of asserting frivolous issues or being solely for the purpose of delaying proceedings.<sup>14</sup> Two taxpayers were represented by attorneys; all 41 others appeared *pro se* (represented themselves). The taxpayers in these cases presented a wide variety of arguments that the courts have generally rejected on numerous occasions. Upon encountering these arguments, the courts almost invariably cited the language set forth in *Crain v. Commissioner*:

We perceive no need to refute these arguments with somber reasoning and copious citation of precedent; to do so might suggest that these arguments have some colorable merit. The constitutionality of our income tax system—including the role played

<sup>9</sup> IRC § 7482(c)(4) provides that the United States Courts of Appeals and the Supreme Court have the authority to impose a penalty in any case where the Tax Court's decision is affirmed and the appeal was instituted or maintained primarily for delay or the taxpayer's position in the appeal was frivolous or groundless.

<sup>10</sup> 28 U.S.C. § 1912 provides that when the Supreme Court or a United States Court of Appeals affirms a judgment, the court has the discretion to award to the prevailing party just damages for the delay, and single or double costs. 28 U.S.C. § 1927 authorizes federal courts to sanction an attorney or any other person admitted to practice before any court of the United States or any territory thereof for unreasonably and vexatiously multiplying proceedings.

<sup>11</sup> Federal Rule of Appellate Procedure 38 provides that if a United States Court of Appeals determines an appeal is frivolous, the court may award damages and single or double costs to the appellee.

<sup>12</sup> See *Walbaum v. Comm'r*, 387 Fed. Appx. 668 (8th Cir. 2010), *cert. denied*, 131 S. Ct. 1056 (2011) (imposing \$5,000 in damages pursuant to 28 U.S.C. § 1912 for the frivolous appeal).

<sup>13</sup> See, e.g., *Cook v. Comm'r*, T.C. Memo. 2010-137.

<sup>14</sup> See *Anyika v. Comm'r*, T.C. Memo. 2011-69 and *Pace v. Comm'r*, T.C. Memo. 2010-272.

within that system by the Internal Revenue Service and the Tax Court—has long been established.<sup>15</sup>

In the cases we reviewed, taxpayers raised the following issues that the Tax Court deemed frivolous. Consequently, the taxpayers were subject to a penalty under IRC § 6673(a)(1) (or, in some cases, the court warned that such arguments were frivolous and could lead to a penalty in the future if the taxpayers maintained the same positions):

- **Citizens of certain states are not subject to income taxes:** At least four taxpayers argued that as residents of a “sovereign,” “compact,” or “independent” state, they are not subject to income taxes imposed by the United States government.<sup>16</sup> The Tax Court imposed penalties of \$1,000<sup>17</sup> to \$5,000<sup>18</sup> in these cases.
- **IRS forms and notices violate the Paperwork Reduction Act because they do not display a valid Office of Management and Budget (OMB) Control Number:** In at least two cases, taxpayers argued that IRS forms and notices violated the Paperwork Reduction Act (PRA), and therefore the taxpayers had no duty to file tax returns.<sup>19</sup> Under the PRA, OMB is given authority to review an agency “collection of information” and to assign a control number to each “collection of information” it approves.<sup>20</sup> If a “collection of information” does not display a current control number or fails to state that the request for information is not subject to the PRA, the PRA provides that a person cannot be subject to a penalty for the failure to maintain or provide information.<sup>21</sup> These taxpayers argued that because certain IRS forms and notices do not contain OMB control numbers, the PRA protects them from any penalties for failure to comply with the IRS’s request for information. The courts have consistently rejected such arguments.<sup>22</sup>
- **Only income earned from the United States government or entities associated with the United States government is taxable:** Taxpayers in at least three cases presented arguments that only federal government employees, public servants, those who earn income from the United States government, or those who earn income from federally licensed corporations are subject to the income tax.<sup>23</sup>

<sup>15</sup> *Crain v. Comm’r*, 737 F.2d 1417, 1417-18 (5th Cir. 1984).

<sup>16</sup> See, e.g., *Callahan v. Comm’r*, T.C. Memo. 2010-201 and *Mooney v. Comm’r*, T.C. Memo. 2011-35.

<sup>17</sup> See *McLaurine v. Comm’r*, T.C. Memo. 2010-236.

<sup>18</sup> See *Burchfield v. Comm’r*, T.C. Memo. 2011-30.

<sup>19</sup> See *Hyde v. Comm’r*, T.C. Memo. 2011-104 and *Antolick v. Comm’r*, 107 A.F.T.R.2d (RIA) 1768 (11th Cir. 2011), *aff’g* Tax Ct. No. 21635-08L.

<sup>20</sup> 44 U.S.C. §§ 3502, 3504, 3507(a).

<sup>21</sup> 44 U.S.C. § 3512.

<sup>22</sup> See *U.S. v. Dawes*, 951 F.2d 1189, 1191-93 (10th Cir. 1991) (citations omitted); *Pitts v. Comm’r*, T.C. Memo. 2010-101.

<sup>23</sup> See, e.g., *Burchfield v. Comm’r*, T.C. Memo. 2011-30.

## CONCLUSION

Taxpayers in the cases analyzed this year presented the same arguments raised and repeated year after year, which the courts routinely and universally reject.<sup>24</sup> Taxpayers avoided the IRC § 6673 penalty in only seven cases where the IRS requested it, demonstrating the willingness of the courts to penalize taxpayers when they offer frivolous arguments or institute a case merely for delay. Where the IRS has not requested the penalty, the court may nonetheless raise the issue *sua sponte*, and in many cases imposes the penalty or cautions the taxpayer that similar future behavior will result in a penalty.<sup>25</sup> Finally, the U.S. Courts of Appeals have shown their willingness to uphold the penalties imposed by the Tax Court without fail in the cases analyzed for the period between June 1, 2010, and May 31, 2011.

<sup>24</sup> See, e.g., National Taxpayer Advocate 2010 Annual Report to Congress 479-482.

<sup>25</sup> See, e.g., *Hyde v. Comm'r*, T.C. Memo. 2011-104 (court raised the issue *sua sponte* and found taxpayer liable for \$3,000 penalty).

MLI  
#10**Charitable Deductions Under Internal Revenue Code Section 170****SUMMARY**

Subject to certain limitations, taxpayers can take a deduction from their adjusted gross income for contributions of cash or other property to charitable organizations.<sup>1</sup> Taxpayers must contribute to certain qualifying organizations,<sup>2</sup> and are required to substantiate contributions of \$250 or more.<sup>3</sup> 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 from June 1, 2010, through May 31, 2011, with charitable deductions as a contested issue. The IRS prevailed in 22 cases (81 percent) and there were five split decisions (*i.e.*, the court ruled partially in favor of the taxpayer and partially in favor of the government). Taxpayers appeared *pro se* in 13 of the 27 cases (48 percent).

**PRESENT LAW**

Taxpayers can generally take a deduction for charitable contributions made within the taxable year.<sup>4</sup> For individuals, these deductions are generally limited to 50 percent of the taxpayer's contribution base (adjusted gross income computed without regard to any net operating loss carryback to the taxable year under IRC § 172).<sup>5</sup> However, subject to certain limitations, individual taxpayers can carry forward unused charitable contributions in excess of the 50 percent base for up to five years.<sup>6</sup> Corporate charitable deductions are generally limited to ten percent of the taxpayer's taxable income.<sup>7</sup> Taxpayers cannot deduct services that they offer to charitable organizations; however, incidental expenditures

<sup>1</sup> Internal Revenue Code (IRC) § 170.

<sup>2</sup> To claim a charitable contributions deduction, a taxpayer must establish that a gift was made to a qualified entity organized and operated exclusively for an exempt purpose, no part of the net earnings of which inures to the benefit of any private shareholder or individual. IRC § 170(c)(2).

<sup>3</sup> IRC § 170(f)(8).

<sup>4</sup> IRC § 170(a)(1).

<sup>5</sup> IRC §§ 170(b)(1)(A), (G). While the 50 percent contribution base limitation applies to most charitable organizations, deductions are limited to 30 percent of the taxpayer's contribution base for gifts to certain specific types of organizations, including veterans' organizations, fraternal societies, nonprofit cemeteries, and certain private non-operating foundations. IRC § 170(b)(1)(B). Moreover, the allowable deduction is reduced if the charitable gift is a capital gain property for which the deduction is calculated using fair market value without a reduction for appreciation; in this case, the allowable deduction is reduced to 30 percent for 50-percent organizations and to 20 percent for 30-percent organizations, respectively. IRC §§ 170(b)(1)(C), (D).

<sup>6</sup> IRC § 170(d)(1).

<sup>7</sup> IRC § 170(b)(2).

incurred while serving a charitable organization and not reimbursed may constitute a deductible contribution.<sup>8</sup>

### Substantiation

Deductions for charitable contributions of \$250 or more are disallowed in the absence of a contemporaneous written receipt from the recipient.<sup>9</sup> For cash contributions, taxpayers must maintain receipts from the charitable organization, copies of cancelled checks, or other reliable records showing the name of the organization, the date, and the amount contributed.<sup>10</sup> For each contribution of property other than money, taxpayers generally must maintain a receipt showing the name of the recipient, the date and location of the contribution, and a description of the property.<sup>11</sup> When property other than money is contributed, the amount of the allowable deduction is the fair market value of the property at the time of the contribution.<sup>12</sup>

### Cohan Doctrine

In cases where taxpayers have provided credible evidence they made a charitable contribution but have difficulty substantiating the precise amount, a judicial doctrine has evolved that allows courts to determine, based on the best evidence at hand, the amount of the contribution.<sup>13</sup> The *Cohan* doctrine does not relieve the taxpayer of the responsibility of substantiating his or her charitable contribution, although it can assist taxpayers who can demonstrate that contributions were made, but have not kept records of the amounts.<sup>14</sup>

## ANALYSIS OF LITIGATED CASES

We reviewed 27 opinions entered between June 1, 2010, and May 31, 2011, involving the allowance of a charitable contribution deduction. Table 10 in Appendix III contains a detailed list of those cases. Of the 27 cases, one involved the issue of whether the recipient was a

<sup>8</sup> Treas. Reg. § 1.170A-1(g). Meal expenditures in conjunction with offering services to qualifying organizations are not deductible unless the expenditures are away from the taxpayer's home. *Id.* Likewise, travel expenses associated with contribution are not deductible if there is a significant element of personal pleasure involved with the travel. IRC § 170(j).

<sup>9</sup> IRC § 170(f)(8); see also Treas. Reg. § 1.170A-13(f).

<sup>10</sup> Treas. Reg. § 1.170A-13(a)(1).

<sup>11</sup> Treas. Reg. § 1.170A-13(b)(1).

<sup>12</sup> Treas. Reg. § 1.170A-1(c)(1). Note that the fair market value must be reduced for certain contributions of ordinary income and capital gain property. See IRC § 170(e).

<sup>13</sup> *Cohan v. Comm'r*, 39 F.2d 540, 543-44 (2d Cir. 1930). In *Cohan*, a theatrical production manager claimed unsubstantiated deductions for the entertainment of actors, employees, and critics. He did not maintain records of these expenses, but knew they were substantial sums. The Second Circuit determined that the Board of Tax Appeals was authorized to estimate unsubstantiated taxpayer expenses when it is certain that expenses were incurred, but the amount could not be quantified. *Id.* at 543.

<sup>14</sup> As a general rule, if the trial record provides sufficient evidence that the taxpayer has incurred a deductible expense, but the taxpayer is unable to substantiate adequately the precise amount of the deduction to which he or she is otherwise entitled, the Court may estimate the amount of the deductible expense and allow the deduction to that extent. In these instances, the Court is permitted to make as close an approximation of the allowable expense as it can, bearing heavily against the taxpayer whose inexactitude is of his or her own making. See *Cohan v. Comm'r*, 39 F.2d 540, 543-44. However, in order for the Court to estimate the amount of an expense, the Court must have some basis upon which an estimate may be made. See *Vanicek v. Comm'r*, 85 T.C. 731, 743 (1985).

qualified charitable organization,<sup>15</sup> five cases involved a dispute over the valuation of the property,<sup>16</sup> three cases involved the issue of whether the property contributed qualified as a deductible contribution,<sup>17</sup> and 16 involved the taxpayers' substantiation (or lack thereof) of the claimed contributions.<sup>18</sup> None of the taxpayers were entitled to a charitable contribution deduction in full. However, the court partially allowed the deduction in five cases.

### Qualifying Charitable Organization

To be deductible, a contribution must be made to a qualifying organization.<sup>19</sup> In one case, the taxpayers' deductions were rejected for failing to meet this threshold test. The Tax Court held that the taxpayers failed to prove the organization to which they made donations was an entity eligible to receive charitable contributions under IRC § 170.<sup>20</sup>

### Qualified Contribution

To constitute a qualified contribution for purposes of IRC § 170, the donor-taxpayer must possess a transferable property interest in the property and intend to irrevocably relinquish all rights, title, and interest to the property without an expectation of some benefit in return.<sup>21</sup> In two of the cases we reviewed, the courts disallowed the deduction because the taxpayers received a substantial benefit from the charitable donation. In *Viralam v. Commissioner*, the taxpayer-husband sold his medical practice and reported a gain from the sale.<sup>22</sup> He then transferred the proceeds of sale to a foundation. Several years later, the foundation lent the taxpayers' son funds to pay for college. The taxpayers presented no evidence that the foundation exercised any judgment in selecting their son for a student loan. The Tax Court disallowed the charitable deductions to the foundation because the taxpayers maintained dominion and control over the contributions and received a substantial benefit.<sup>23</sup> In another case, the court denied the taxpayers' charitable contribution deduction because the value of the services the taxpayers received exceeded the value of the property donated. In that case, the taxpayers donated their lake house, but no real property, to the fire department so that the fire department could use the house for firefighter training and eventual demolition. The Tax Court held that the taxpayers were not entitled

<sup>15</sup> *Ahmadian v. Comm'r*, T.C. Summ. Op. 2010-126.

<sup>16</sup> *Evans v. Comm'r*, T.C. Memo. 2010-207, *Scheidelman v. Comm'r*, T.C. Memo. 2010-151, *Boltar, LLC v. Comm'r*, 136 T.C. No. 14 (2011), *Trout Ranch, LLC v. Comm'r*, T.C. Memo 2010-283, appeal docketed, No. 11-9006 (10th Cir. Mar. 21, 2011), *Whitehouse Hotel LP v. Comm'r*, 615 F.3d 321 (5th Cir. 2010).

<sup>17</sup> *Kaufman v. Comm'r*, 136 T.C. No. 13 (2010); *Rolfs v. Comm'r*, 135 T.C. 471 (2010), *Viralam v. Comm'r*, 136 T.C. No. 8 (2011).

<sup>18</sup> One case contained more than one of these issues. See *Viralam v. Comm'r*, 136 T.C. No. 8 (2011).

<sup>19</sup> Qualifying charitable organizations include: (1) federal, state or local governments, and (2) corporations, trusts or funds organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals, no part of the net earnings of which inure to the benefit of a private individual or shareholder. See IRC § 170(c) for a full description of qualifying organizations.

<sup>20</sup> *Ahmadian v. Comm'r*, T.C. Summ. Op. 2010-126.

<sup>21</sup> IRC § 170(f)(3) requires that taxpayers relinquish all rights, title and interest in property contributed.

<sup>22</sup> *Viralam v. Comm'r*, 136 T.C. No. 8 (2011).

<sup>23</sup> *Id.*

to a charitable contribution deduction because the value of the demolition far exceeded the value of the property donated.<sup>24</sup>

### Valuation

Five cases involved disputes between the IRS and taxpayers over the value of property contributed. When taxpayers contribute non-cash items, they must determine the fair market value of the property as of the date of the contribution.<sup>25</sup> Fair market value is the price at which the property would change hands between a willing buyer and a willing seller.<sup>26</sup> Determining the fair market value of non-cash property with precision can be difficult for taxpayers, especially when easements are being donated.

Of the five cases involving disputes over the value of property contributed, four involved the valuation of easements.<sup>27</sup> In *Evans v. Commissioner*,<sup>28</sup> the taxpayers claimed a charitable contribution deduction for a donation of façade easements to a qualified conservation organization. The taxpayers failed to provide credible evidence of the fair market value of the easements; thus, the court found the taxpayers were not entitled to deduct them as charitable contributions. Taxpayers may provide expert reports or testimony as evidence of valuation. However, to be admissible in court, expert testimony must be based on sufficient facts or data. Further, the testimony must be based on reliable principles and methods, which must be applied to the facts of the case.<sup>29</sup>

In *Boltar v. Commissioner*, the taxpayer claimed a \$3.2 million charitable deduction for an easement donation.<sup>30</sup> Prior to trial, the taxpayer submitted an expert report from an appraisal firm stating that the property's highest and best use was as a condominium development.<sup>31</sup> The report was found to be inadmissible because, among other things, it failed to determine the highest and best use of the property after the easement was granted. The Commissioner's valuation engineers concluded that the highest and best use of the property was for the development of single-family detached residential homes.

### Substantiation

Sixteen cases involved the substantiation of deductions for charitable contributions. The IRS prevailed in full in 15 cases and one ended in a split decision.

<sup>24</sup> *Rolfs v. Comm'r*, 135 T.C. 471 (2010).

<sup>25</sup> Treas. Reg. § 1.170A-1(c)(1).

<sup>26</sup> Treas. Reg. § 1.170A-1(c)(2).

<sup>27</sup> *Boltar, LLC v. Comm'r*, c), *Evans v. Comm'r*, T.C. Memo. 2010-207, *Trout Ranch, LLC v. Comm'r*, T.C. Memo 2010-283, *appeal docketed*, No. 11-9006 (10th Cir. Mar. 21, 2011), *Whitehouse Hotel LP v. Comm'r*, 615 F.3d 321 (5th Cir. 2010).

<sup>28</sup> T.C. Memo. 2010-207.

<sup>29</sup> Fed. R. Evid. 702. An expert report that is not based on sufficient facts or data and does not state the facts or data and detailed reasons for the conclusions, as required by U.S. Tax Ct. R. 143(g), is not admissible as expert testimony or as an expert report in a matter before the U.S. Tax Court.

<sup>30</sup> 136 T.C. No. 14 (2011).

<sup>31</sup> The concept of "highest and best use" is an element in the determination of fair market value.

In *Lang v. Commissioner*, the taxpayer (a freelance “voice-over” artist) claimed a charitable deduction for local transportation expenses for a play for which he volunteered services.<sup>32</sup> These deductions were disallowed since the taxpayer offered no other evidence, other than his testimony, to prove how he calculated the claimed amount.

When determining whether or not a claimed charitable deduction is adequately substantiated, courts tend to follow a strict interpretation of IRC § 170. For example, in *Hendrix v. United States*, the taxpayers (husband and wife) reported a charitable deduction for their donated house to the city for fire training.<sup>33</sup> The court denied the deduction because the taxpayers failed to provide a valid appraisal under IRC § 170(f)(11)(E)(i)(I), and also because they did not provide a contemporaneous acknowledgment that met the requirements of IRC § 170(f)(8). Further, in *Schrimsher v. Commissioner*,<sup>34</sup> the taxpayers granted a facade easement to the Alabama Historical Commission and claimed the property as a charitable contribution. The court denied the deduction because, although the taxpayers produced a written contemporaneous acknowledgement, it did not state whether the taxpayers received any goods or services from the historical commission in consideration of the contribution as required under IRC § 170(f)(8)(B)(ii).

### Pro Se Analysis

In 13 of the 27 cases we reviewed, taxpayers were *pro se*. None of the taxpayers who appeared *pro se* were entitled to a charitable deduction in full, but one of the five taxpayers who received partial relief was *pro se*. With respect to relief, there does not appear to be a correlation between represented taxpayers and those who were *pro se*, since, like *pro se* taxpayers, no represented taxpayers were found to be entitled to a charitable deduction in full.

## CONCLUSION

IRC § 170 and the applicable Treasury Regulations provide detailed requirements as to what constitutes adequate substantiation for a charitable deduction. Cases such as *Hendrix v. United States*<sup>35</sup> and *Schrimsher v. Commissioner*<sup>36</sup> demonstrate that courts strictly interpret IRC § 170 and its accompanying regulations.

<sup>32</sup> T.C. Memo 2010-152.

<sup>33</sup> 106 A.F.T.R.2d (RIA) 5373 (S.D. Ohio 2010).

<sup>34</sup> T.C. Memo 2011-71.

<sup>35</sup> T.C. Memo 2010-152.

<sup>36</sup> T.C. Memo 2011-71.

## Case Advocacy

### Activities of the Office of the Taxpayer Advocate

Under Internal Revenue Code (IRC) § 7803(c), the Office of the Taxpayer Advocate has four principal functions:

- Assist taxpayers in resolving problems with the IRS;
- Identify areas in which taxpayers are experiencing problems with the IRS;
- Propose changes in the administrative practices of the IRS to mitigate problems taxpayers are experiencing with the IRS; and
- Identify potential legislative changes which may be appropriate to mitigate such problems.

Taxpayer Advocate Service (TAS) employees assist taxpayers whose tax problems are causing financial difficulty, who are seeking help in resolving tax problems that have not been resolved through normal channels, or who believe an IRS system or procedure is not working as it should. And while all IRS personnel must consider and protect taxpayer rights, TAS employees have a special responsibility for ensuring that taxpayers are treated fairly by the IRS.

In addition to helping taxpayers with specific cases and individual problems, TAS employees advocate for taxpayers by identifying IRS procedures that adversely impact taxpayer rights or create taxpayer burden, recommending solutions to taxpayer problems, and working with the IRS to improve tax administration. TAS serves as the voice of the taxpayer within the IRS by providing the taxpayer's viewpoint when the IRS is considering new policies, procedures, or programs. Additionally, TAS administers the Low Income Taxpayer Clinic (LITC) grant program<sup>1</sup> and oversees the Taxpayer Advocacy Panel (TAP).<sup>2</sup>

### TAS Analyzes Economic and Systemic Burden Case Receipts for Process Improvements.

Taxpayers come to TAS with specific cases when:

- They have experienced a tax problem that causes financial difficulty;
- They have encountered problems trying to resolve their issues directly with the IRS; or
- An IRS action or inaction has caused or will cause them to suffer a long-term adverse impact, including a violation of taxpayer rights.

<sup>1</sup> The LITC program provides matching grants to qualifying organizations to operate clinics that represent low income taxpayers in disputes with the IRS, or educate taxpayers for whom English is a second language about their rights and responsibilities as U.S. taxpayers. LITCs provide services to eligible taxpayers for free or for no more than a nominal fee. See IRC § 7526.

<sup>2</sup> TAP is a Federal Advisory Committee established by the Department of the Treasury to provide a taxpayer perspective on improving IRS service to taxpayers. TAS provides oversight and support to the TAP program. The Federal Advisory Committee Act (5 U.S.C. Appendix) prescribes standards for establishing advisory committees when those committees will furnish advice, ideas, and opinions to the federal government. See *also* 41 C.F.R. Part 102-3.

TAS generally accepts cases in four categories:

- Economic Burden – Cases in which a taxpayer is experiencing financial difficulty;
- Systemic Burden – Cases in which an IRS process, system, or procedure has failed to operate as intended, and as a result, the IRS has failed to timely respond to or resolve a taxpayer’s issue;
- Equitable Treatment or Taxpayer Rights Issues – Cases accepted to ensure taxpayers receive fair and equitable treatment and taxpayers’ rights are protected; and
- Public Policy – Cases accepted when the National Taxpayer Advocate determines compelling public policy warrants assistance to an individual or group of taxpayers.

In fiscal year (FY) 2011, TAS received 295,904 cases, a one percent decrease from FY 2010, and provided relief to taxpayers in 75.7 percent of cases closed.<sup>3</sup> Figure 4.1 shows the FY 2011 receipts and closures by case category.

**FIGURE 4.1, TAS Case Receipts, Closures, And Relief Rates<sup>4</sup>**

|   | FY 2011 Receipts | FY 2011 Closures | Relief Rate  |
|---|------------------|------------------|--------------|
| Economic Burden                               | 131,482          | 127,615          | 72.7%        |
| Systemic Burden                               | 164,173          | 167,549          | 78.0%        |
| Equitable Treatment or Taxpayer Rights Issues | 216              | 222              | 73.0%        |
| Public Policy                                 | 33               | 24               | 79.2%        |
| <b>Total Cases</b>                            | <b>295,904</b>   | <b>295,410</b>   | <b>75.7%</b> |

As reflected above, the bulk of TAS’s cases involve either economic or systemic burden. While TAS strives to expeditiously resolve all cases meeting TAS criteria, it places special emphasis on helping taxpayers who are experiencing financial difficulty (*i.e.*, economic burden). In these instances, TAS requires case advocates to take specific actions to expedite initial case processing, and to contact the taxpayer to communicate these actions and request additional information (if needed) within three workdays of the date TAS received the case.<sup>5</sup>

While TAS received slightly fewer cases overall in FY 2011 than in FY 2010, the number of economic burden receipts continues to grow. As noted above, these cases require quicker action. As shown in Figure 4.2, economic burden cases increased by nearly ten percent

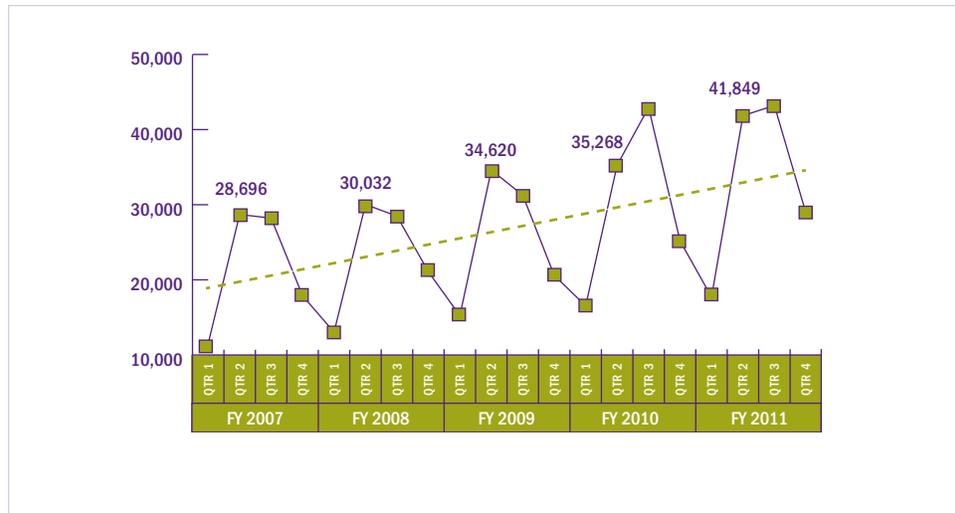
<sup>3</sup> TAS determines relief based upon whether TAS can provide full or partial relief or assistance on the issue initially identified by the taxpayer. Because TAS frequently provides relief on issues that differ from the ones first identified, the relief rate, as calculated, is understated. Data obtained from the Taxpayer Advocate Management Information System (TAMIS) (Oct. 1, 2011). TAS uses TAMIS to record, control, and process taxpayer cases, as well as to analyze the issues that bring taxpayers to TAS.

<sup>4</sup> Data obtained from TAMIS. TAS tracks resolution of taxpayer issues through codes entered at the time of closing on TAMIS and requires case advocates to indicate the type of relief or assistance they provide to the taxpayer. See Internal Revenue Manual (IRM) 13.1.21.1.2.1.2 (Feb. 1, 2011). The codes reflect full relief, partial relief, or assistance provided. The relief rate is determined by dividing the total number of cases closed with full relief, partial relief, or assistance by the total number of closures.

<sup>5</sup> IRM 13.1.18.2(1) (Feb. 1, 2011).

in FY 2011 compared to FY 2010. These receipts also have risen more than 52 percent compared to FY 2007.<sup>6</sup>

**FIGURE 4.2, TAS Economic Burden Receipts By Quarter, FY 2007- 2011<sup>7</sup>**



With the nation's unemployment rate hovering around nine percent<sup>8</sup> and the housing market showing few signs of recovery,<sup>9</sup> it is hardly surprising that taxpayers facing economic burden are coming to TAS for assistance. However, to identify the immediate cause behind the increase in receipts, TAS tracks the underlying tax issues. Figure 4.3 lists the top five economic burden issues in FY 2011.

<sup>6</sup> Data obtained from TAMIS (Oct. 1, 2007; Oct. 1, 2010; Oct. 1, 2011).

<sup>7</sup> Data obtained from TAMIS (Oct. 1, 2011).

<sup>8</sup> Bureau of Labor Statistics, *The Employment Situation – September 2011*, USDL-11-1441 (Oct. 7, 2011). The unemployment rate was 9.1 percent in September 2011. “Since April, the rate has held in a narrow range from 9.0 to 9.2 percent.”

<sup>9</sup> RealtyTrac Staff, *Foreclosure Activity Off 29 Percent for First Half of 2011* (July 13, 2011), available at <http://www.realtytrac.com/content/press-releases/midyear-2011-us-foreclosure-market-report-6681>. RealtyTrac states: “Processing and procedural delays are pushing foreclosures further and further out – we estimate that as many as 1 million foreclosure actions that should have taken place in 2011 will now happen in 2012, or perhaps even later. This casts an ominous shadow over the housing market, where recovery is unlikely to happen until the current and forthcoming inventory of distressed properties can be whittled down to a manageable number.”

**FIGURE 4.3, Top Five Economic Burden Case Issues FY 2010 and FY 2011<sup>10</sup>**

| Rank | Issue Description   | FY 2010 | FY 2011 | Percentage Change |
|------|---|---------|---------|-------------------|
| 1    | Identity Theft  | 7,655   | 21,500  | 180.9%            |
| 2    | Levies (including Federal Payment Levy Program) <sup>11</sup> | 15,263  | 13,299  | -12.9%            |
| 3    | Unpostable and Reject Returns <sup>12</sup>                   | 10,500  | 8,658   | -17.5%            |
| 4    | Pre-Refund Wage Verification Hold <sup>13</sup>               | 1,210   | 8,616   | 554.6%            |
| 5    | Open Audit (not Earned Income Tax Credit)                     | 9,778   | 8,411   | -14.0%            |

Identity theft is the number one issue in economic burden case receipts and, as shown in the next section, it is currently the leading reason that taxpayers seek TAS assistance.<sup>14</sup> In FY 2011, economic burden identity theft receipts rose nearly 181 percent compared to FY 2010. Of the 34,006 taxpayers who came to TAS with this issue during FY 2011, 21,500 or 63 percent were experiencing economic burden.<sup>15</sup>

Levy issues are second on the list of issues in economic burden cases. As shown above, however, economic burden levy receipts have decreased nearly 13 percent from FY 2010 to FY 2011.

### ***Collection Issues Continue to Contribute Significantly to TAS Economic Burden Receipts.***

In FY 2011, collection issues accounted for more than 18 percent of all economic burden receipts and nearly 13 percent of TAS's total caseload. TAS provided relief for nearly 67 percent of the taxpayers in the total collection cases closed.<sup>16</sup> In addition, in FY 2011 TAS issued 57 Taxpayer Assistance Orders (TAOs) in collection cases where the IRS did not

<sup>10</sup> Data obtained from TAMIS (Oct. 1, 2011; Oct. 1, 2010). TAS computed the top five economic burden cases using only Primary Issue Codes (PIC). Often TAS cases involve more than one issue and TAS tracks this data, however these are not included within this computation to avoid counting a case more than once.

<sup>11</sup> The Federal Payment Levy Program (FPLP) is a systemic collection enforcement tool authorized by IRC § 6331(h). It allows the IRS to levy on federal payments disbursed by the Treasury's Financial Management Service (FMS) to taxpayers with an outstanding tax liability. Each week, the IRS creates a file of certain balance due accounts and transmits the file to FMS's Treasury Offset Program. FMS transmits a weekly file back to the IRS listing those that matched. FPLP will subsequently transmit levies on matching accounts. For a detailed discussion of FPLP issues, see Most Serious Problem: *The New Income Filter For The Federal Payment Levy Program Does Not Fully Protect Low Income Taxpayers From Levies On Social Security Benefits*, *supra*.

<sup>12</sup> Each account transaction, including tax return processing, is subjected to a series of validity checks before posting to the IRS Master File. A transaction is termed unpostable when it fails to pass any of the checks and is returned to the campus (Rejects Function) for follow-up action(s). IRM 21.5.5.2 (Oct. 1, 2007).

<sup>13</sup> Because TAS did not use PIC 045 until March 24, 2010, a more appropriate comparison would be between the economic burden PIC 045 receipts from the last two quarters of FY 2011 (6,913 cases) and the last two quarters of FY 2010 (1,056 cases), which represents a 554.6 percent increase. The 8,616 economic burden pre-refund wage verification (PIC 045) cases actually represent a 612 percent increase over the 1,210 PIC 045 cases received in FY 2010. For more information about pre-refund wage verification holds, see Most Serious Problem: *The IRS's Wage and Withholding Verification Procedures May Encroach on Taxpayer Rights and Delay Refund Processing*, *supra*.

<sup>14</sup> For a more detailed discussion of identity theft issues, see Most Serious Problem: *Tax-Related Identity Theft Continues to Impose Significant Burden on Taxpayers and the IRS*, *supra*.

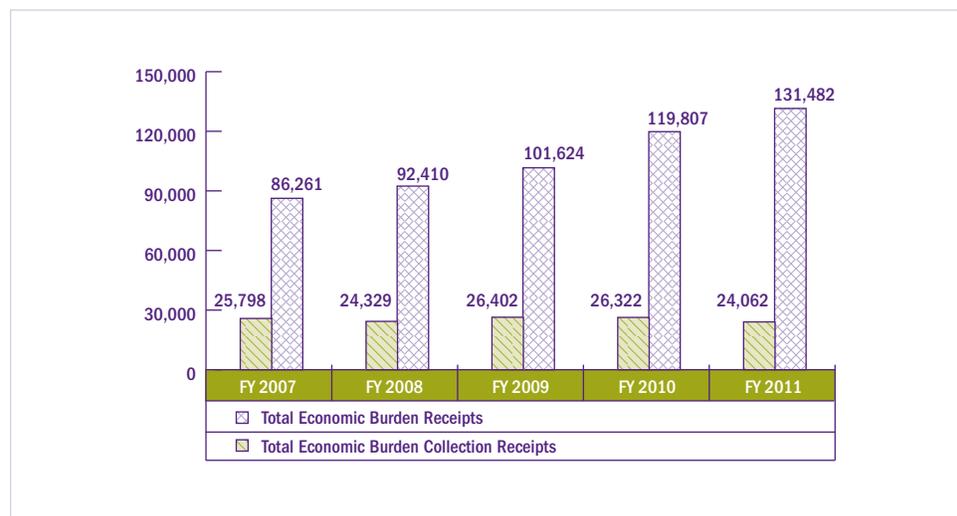
<sup>15</sup> Data obtained from TAMIS (Oct. 1, 2011).

<sup>16</sup> *Id.*

agree with TAS's case-specific recommendations, of which the IRS complied with 44, TAS rescinded six, and seven are still in process.<sup>17</sup>

As shown in Figure 4.4, while economic burden cases overall have increased more than 52 percent from FY 2007 to FY 2011, economic burden receipts resulting from IRS collection issues dropped nearly seven percent.

**FIGURE 4.4, TAS Total and Collection Economic Burden Receipts, FY 2007 Through FY 2011<sup>18</sup>**



While collection issues continue to be a significant source of TAS economic burden receipts, in FY 2011 these cases have declined by more than eight percent from FY 2010, from 26,322 to 24,062. Nearly 20 percent of this decline is attributable to a policy and programming change designed to prevent harm to low income Social Security beneficiaries.<sup>19</sup>

#### **THE IRS SCREENS OUT LOW INCOME TAXPAYERS FROM LEVIES ON SOCIAL SECURITY.**

This change affects the FPLP, an automated system that allows the IRS to issue continuous levies up to 15 percent of certain federal payments to collect taxpayers unpaid federal tax liabilities.<sup>20</sup> While FPLP levies can attach to a variety of federal sources of income, ranging from salaries to retirement income to federal contractor (or vendor) payments, the bulk of FPLP levy payments have historically been related to Social Security benefits. Over the years, the National Taxpayer Advocate has continuously advocated for an FPLP screening filter, and in recent years has worked with the IRS on a research project to create and implement a filter to protect low income taxpayers from being harmed by the

<sup>17</sup> For a detailed discussion of TAOs, see *TAS Uses Taxpayer Assistance Orders to Advocate Effectively in Taxpayer Cases*, *infra*.

<sup>18</sup> Data obtained from TAMIS (Oct. 1, 2007; Oct. 1, 2008; Oct. 1, 2009; Oct. 1, 2010; and Oct. 1, 2011).

<sup>19</sup> Data obtained from TAMIS, Oct. 1, 2010 (FY 2010 data) and Oct. 1, 2011 (FY 2011 data).

<sup>20</sup> IRC § 6331(h)(2)(A), as prescribed by the Taxpayer Relief Act of 1997, Pub. L. No. 105-34 § 1024, 111 Stat. 788, 923 (1997) authorizes the IRS to issue continuous levies on certain federal payments.

FPLP.<sup>21</sup> On January 23, 2011, the IRS implemented an FPLP screening filter developed by TAS and the IRS. Each month, the Low Income Filter (LIF) systemically identifies and screens out taxpayers from inclusion in the FPLP if they have income at or below 250 percent of the federal poverty level.<sup>22</sup> This filter is intended to protect low income taxpayers from experiencing an economic hardship due to a levy on their Social Security old age or disability benefits, and to ensure that the IRS does not issue levies that it would likely have to release immediately on the grounds of economic hardship.<sup>23</sup> The National Taxpayer Advocate is generally pleased with its development.

Since the IRS implemented filter, TAS receipts concerning FPLP levies on Social Security benefits declined more than 22 percent, from 2,827 FPLP economic burden cases in FY 2010 to 2,198 in FY 2011 (nearly 20 percent of the total decline in economic burden collection receipts during FY 2011).<sup>24</sup> However, the filter's effectiveness has not yet been tested.<sup>25</sup> Further, the National Taxpayer Advocate is concerned that the filter still leaves some taxpayers subject to the FPLP, even though their incomes otherwise fit the guidelines (*i.e.*, taxpayers who have an unfiled return or an outstanding business debt).<sup>26</sup>

#### TAS CONTINUES TO ADVOCATE FOR CHANGES IN LIEN FILING POLICIES.

The National Taxpayer Advocate has repeatedly expressed concern about the adverse impact of IRS lien filing policies on taxpayers and future compliance.<sup>27</sup> She has proposed several administrative and legislative steps to improve these policies and procedures, and to grant relief to taxpayers harmed by automatic Notice of Federal Tax Lien (NFTL) filings.<sup>28</sup> In response, the IRS announced a new effort to help financially struggling taxpayers

<sup>21</sup> See *e.g.*, National Taxpayer Advocate 2009 Annual Report to Congress 318–319 (Status Update: *Federal Payment Levy Program: IRS Agrees to Low Income Taxpayer Filter*).

<sup>22</sup> Small Business/Self-Employed Division (SB/SE), *New Federal Payment Levy Program (FPLP) and Railroad Retirement Low Income Filter* (Feb. 4, 2010). The Department of Health and Human Services issues annual poverty guidelines used to determine financial eligibility for certain federal programs.

<sup>23</sup> IRC § 6343(a) and Treas. Reg. § 301.6343-1(b)(4); IRS, Servicewide Electronic Research Program Alert, *New Low Income Filter (LIF) Analysis for the Federal Payment Levy Program (FPLP)* (Jan. 20, 2011).

<sup>24</sup> Data obtained from TAMIS, Oct. 1, 2011 (FY 2011 data), Oct. 1, 2010 (FY 2010 data). Since the IRS implemented the filter (from January through September 2011), TAS FPLP cases have declined by 26.6 percent compared to the same period in 2010. Data obtained from TAMIS (Nov. 9, 2011).

<sup>25</sup> Email from Wage and Investment Division (W&I) senior analyst to TAS senior researcher (Oct. 11, 2011). The IRS will not complete a review of the FPLP LIF until FY 2012.

<sup>26</sup> For a more detailed discussion of FPLP issues and the National Taxpayer Advocate's concerns about how this program is being implemented, see *The New Income Filter For The Federal Payment Levy Program Does Not Fully Protect Low Income Taxpayers From Levies On Social Security Benefits*, *supra*.

<sup>27</sup> National Taxpayer Advocate Fiscal Year 2012 Objectives Report to Congress 12-13; National Taxpayer Advocate 2010 Annual Report to Congress 302-310; National Taxpayer Advocate 2009 Annual Report to Congress 17-40; National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 1-18. See also National Taxpayer Advocate 2009 Annual Report to Congress 357-364.

<sup>28</sup> See Taxpayer Advocate Directive (TAD) 2010-1, Immediately discontinue automatic lien filing on Currently Not Collectible (CNC) hardship accounts with an unpaid balance of \$5,000 or more, require employees to make meaningful notice of federal tax lien (NFTL) filing determinations, and require managerial approval for filings of an NFTL in all cases where the taxpayer has no assets (Jan. 20, 2010); TAD 2010-2, Withdrawal of a notice of federal tax lien (NFTL) where the statutory withdrawal criteria are satisfied, even if the underlying lien has been released (Jan. 20, 2010). For copies of the TADs, see National Taxpayer Advocate Fiscal Year 2011 Objectives Report to Congress, Appendix VIII, available at <http://www.irs.gov/pub/irs-utl/nta2011objectivesfinal.pdf>.

get a “fresh start,” which included several positive changes in how it files and withdraws NFTLs.<sup>29</sup> TAS worked very closely with the Collection function in developing and clearing procedural guidance related to the “Fresh Start” initiative,<sup>30</sup> which included:

- Doubling the dollar threshold for filing most NFTLs from \$5,000 to \$10,000, resulting in fewer NFTLs;<sup>31</sup>
- Changing procedures for NFTL withdrawals after lien releases;<sup>32</sup>
- Withdrawing liens in most cases where certain dollar limits and other conditions are met and a taxpayer enters into a Direct Debit Installment Agreement;<sup>33</sup>
- Including situations where the balance to be reflected on the individual NFTL is less than \$2,500 as a situation where the NFTL should not be filed;<sup>34</sup>
- Creating easier access to installment agreements for more struggling small businesses;<sup>35</sup> and
- Expanding a streamlined offer in compromise program to cover more taxpayers.<sup>36</sup>

In addition, the IRS hosted an Open House on Saturday, July 16, 2011 at dozens of Taxpayer Assistance Centers across the country emphasizing the Fresh Start initiative,<sup>37</sup> and on August 31, the IRS presented a webinar on the initiative for tax professionals.<sup>38</sup> The impact of these changes on IRS collection activities and TAS case receipts will become evident over time. Notwithstanding these positive changes, the IRS still files NFTLs automatically when certain dollar thresholds are met, instead of filing NFTLs only after analyzing the taxpayer’s circumstances to ascertain whether the NFTL is appropriate. As a result, NFTL filings in FY 2011 decreased by only 54,000 or about five percent compared to FY 2010.<sup>39</sup> Although the short-term impact of changes from the Fresh Start initiative appears promising, the decrease in NFTL filings so far has been minimal, given the millions of NFTLs filed in recent years.<sup>40</sup>

<sup>29</sup> IRS, Media Relations Office, IRS Announces New Effort to Help Struggling Taxpayers Get a Fresh Start; Major Changes to Lien Process, IR-2011-20 (Feb. 24, 2011).

<sup>30</sup> IRS Announcement IR-2011-20, IRS Announces New Effort to Help Struggling Taxpayers Get a Fresh Start; Major Changes Made to Lien Process (Feb. 24, 2011).

<sup>31</sup> SB/SE, *Interim Guidance Memorandum*, Control No. SBSE-05-0311-039 (Mar. 28, 2011).

<sup>32</sup> SB/SE, *Interim Guidance Memorandum*, Control No. SBSE-05-0611-037 (June 10, 2011). This guidance was issued in response to TADs 2010-1 and 2010-2. See also National Taxpayer Advocate Fiscal Year 2012 Objectives Report to Congress 12.

<sup>33</sup> SB/SE, *Interim Guidance Memorandum*, Control No. SBSE-05-0411-036 (Apr. 7, 2011).

<sup>34</sup> SB/SE, *Interim Guidance Memorandum*, Control No. SBSE-05-0511-050 (May 13, 2011).

<sup>35</sup> SB/SE, *Interim Guidance Memorandum*, Control No. SBSE-05-0311-038 (Mar. 28, 2011).

<sup>36</sup> SB/SE, *Interim Guidance Memorandum*, Control No. SBSE-05-0511-026 (May 13, 2011).

<sup>37</sup> Special Edition Tax Tip 2011-04, IRS Taxpayer Assistance Centers Open on Saturday July 16 (July 14, 2011).

<sup>38</sup> Headliner Volume 313, IRS Live Presents the Fresh Start Initiative (July 25, 2011).

<sup>39</sup> IRS, Collection Activity Report NO-5000-23, *Collection Workload Indicators* (Oct. 30, 2011); IRS, *Fiscal Year 2010 Enforcement Results*, available at [http://www.irs.gov/pub/irs-utl/2010\\_enforcement\\_results.pdf](http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf).

<sup>40</sup> The IRS filed 5,200,913 NFTLs during FYs 2003-2010. IRS, *Fiscal Year 2010 Enforcement Results*, available at [http://www.irs.gov/pub/irs-utl/2010\\_enforcement\\_results.pdf](http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf).

At the request of the National Taxpayer Advocate, TAS Research & Analysis is conducting a comprehensive, multi-year study of the impact of NFTLs on delinquent taxpayers' current and future payment and filing compliance and their ability to earn income.<sup>41</sup> Preliminary findings show that taxpayers with NFTLs filed against them were generally over ten percent less likely than comparable taxpayers without NFTLs to be compliant in paying current and future liabilities, at least within the first three to five years after the NFTL filing. The study also has confirmed an NFTL's negative impact on the filing compliance behavior and financial viability of affected taxpayers for years after the initial filing. With the preliminary results of the new TAS study in hand, the National Taxpayer Advocate has offered to work with the IRS on new, meaningful lien filing criteria. These standards would be based on the effectiveness of filings to increase revenue, promote future compliance, and minimize economic harm.<sup>42</sup>

### **TAS Identifies Problems and Trends That Negatively Impact Taxpayers, and Advocates to Resolve These Issues.**

By analyzing the underlying issues in individual casework, TAS identifies trends that affect larger groups of taxpayers and uses that information to work with the IRS to resolve the broader issues.<sup>43</sup> Figure 4.5 lists the top 15 issues facing taxpayers.

<sup>41</sup> See TAS Research Study: *Impact of Liens on Taxpayer Compliance Behavior, Preliminary Results*, Vol. 2, *infra*. See also National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 89-100 (TAS Research and Related Studies: *Estimating the Impact of Liens on Taxpayer Compliance Behavior: An Ongoing Research Initiative*).

<sup>42</sup> See Most Serious Problem: *Changes to IRS Lien Filing Practices Are Needed to Improve Future Compliance, Increase Revenue Collection, and Minimize Economic Harm Inflicted on Financially Struggling Taxpayers*, *supra*.

<sup>43</sup> TAS uses a variety of sources to identify systemic problems, including TAS employees, other IRS employees, tax practitioners, members of Congress, LITCs, TAP, and the public. These stakeholders submit systemic issues to TAS through a variety of channels, including the Systemic Advocacy Management System (SAMS) on the IRS employee intranet and the TAS site on IRS.gov (<http://www.irs.gov/advocate>).

**FIGURE 4.5, Top 15 Issues Received In TAS in FY 2011<sup>44</sup>**

| Rank                      | Issue Description   | FY 2010        | FY 2011        | Percentage Change |
|---------------------------|---|----------------|----------------|-------------------|
| 1                         | Identity Theft  | 17,291         | 34,006         | 96.7%             |
| 2                         | Processing Amended Return   | 30,891         | 22,743         | -26.4%            |
| 3                         | Open Audit (not Earned Income Tax Credit)   | 26,182         | 21,397         | -18.3%            |
| 4                         | Pre-Refund Wage Verification Hold <sup>45</sup>   | 3,171          | 21,286         | 504.4%            |
| 5                         | Levies (including Federal Payment Levy Program)   | 18,015         | 15,466         | -14.1%            |
| 6                         | Unpostable and Reject Returns   | 22,341         | 13,288         | -40.5%            |
| 7                         | Reconsideration of Audits <sup>46</sup> and Substitute for Return under IRC § 6020(b) <sup>47</sup> | 12,843         | 11,902         | -7.3%             |
| 8                         | Processing Original Return  | 11,997         | 11,578         | -3.5%             |
| 9                         | Expedite Refund Request   | 11,755         | 9,386          | -20.2%            |
| 10                        | Earned Income Tax Credit  | 11,198         | 8,729          | -22.0%            |
| 11                        | Injured Spouse Claim  | 7,777          | 8,295          | 6.7%              |
| 12                        | IRS Offset  | 6,865          | 6,995          | 1.9%              |
| 13                        | Returned and Stopped Refunds  | 6,115          | 6,489          | 6.1%              |
| 14                        | Other Refund Inquiries and Issues   | 6,707          | 6,135          | -8.5%             |
| 15                        | Installment Agreements  | 6,039          | 5,899          | -2.3%             |
| <b>Total TAS Receipts</b> |   | <b>298,933</b> | <b>295,904</b> | <b>-1.0%</b>      |

Significant trends include the continued rise in identity theft receipts, the reappearance of the Questionable Refund Program (QRP)<sup>48</sup> in the form of Pre-Refund Wage Verification Hold cases, and the IRS's difficulties administering the First-Time Homebuyer Credit (FTHBC) and the Adoption Credit, discussed below.

<sup>44</sup> Data obtained from TAMIS (Oct. 1, 2010; Oct. 1, 2011). TAS computed the Top 15 cases using only Primary Issue Codes. Often TAS cases involve more than one issue and TAS tracks this data, however these are not included within this computation to avoid counting a case more than once. Data reflect only the top 15 issues, not all TAS receipts for the FY.

<sup>45</sup> Because TAS did not use PIC 045 until March 24, 2010, a more appropriate comparison would be between PIC 045 case receipts from the last two quarters of FY 2011 (18,018 cases) and the last two quarters of FY 2010 (2,981 cases), which represents a 504.4 percent increase. The 21,286 pre-refund wage verification (PIC 045) cases actually represent a 571 percent increase over the 3,171 PIC 045 cases received in FY 2010. For more information about pre-refund wage verification holds, see Most Serious Problem: *The IRS's Wage and Withholding Verification Process May Encroach on Taxpayer Rights and Delay Refund Processing*, *supra*.

<sup>46</sup> The IRS uses audit reconsideration to reevaluate the results of a prior audit where additional tax was assessed and remains unpaid, or a tax credit was reversed. IRM 21.5.10.4.3 (Oct. 1, 2010).

<sup>47</sup> IRC § 6020(b) allows the IRS to prepare a return on behalf of the taxpayer based on available information, and assess the tax after providing a statutory notice deficiency to the taxpayer.

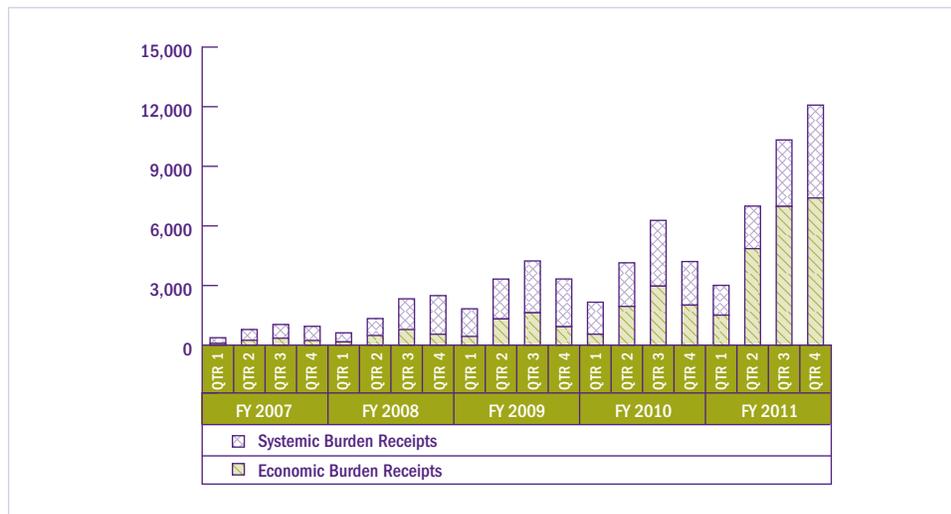
<sup>48</sup> The IRS Criminal Investigation (CI) QRP identifies fraudulent returns, stopping the payment of fraudulent refunds, and referring fraudulent refund schemes to CI field offices. See National Taxpayer Advocate 2007 Annual Report to Congress 448-458 (Status Update: *Questionable Refund Program*); National Taxpayer Advocate 2006 Annual Report to Congress 408-421 (Status Update: *Major Improvements in the Questionable Refund Program and Some Continuing Concerns*); National Taxpayer Advocate 2005 Annual Report to Congress 25-54 (Most Serious Problem: *Criminal Investigation Refund Freezes*); National Taxpayer Advocate 2003 Annual Report to Congress 175-181 (Most Serious Problem: *Criminal Investigation Freezes*).

**The IRS Needs to Make More Improvements to its Handling of Identity Theft Cases.**

Effective June 2010, W&I's Identity Protection Specialized Unit (IPSU) began working non-economic burden identity theft (IDT) cases.<sup>49</sup> In FY 2010, the IPSU handled nearly 3,400 cases that TAS would otherwise have received; in FY 2011 this number increased to nearly 26,700.<sup>50</sup>

However, despite this process improvement, IDT ranked as the number one reason taxpayers came to TAS in FY 2011. TAS IDT receipts continued to increase substantially in FY 2011, as reflected in Figure 4.6 below.

**FIGURE 4.6, TAS Identity Theft Receipts, FY 2007 – FY 2011, Economic and Systemic Burden<sup>51</sup>**



TAS is also participating in a servicewide Identity Theft Assessment Action Group (ITAAG) created to address identity theft challenges, which include:

- Keeping pace with a growing, increasingly complex caseload;

<sup>49</sup> See Memorandum of Understanding Between the National Taxpayer Advocate and the Commissioner, W&I to Transition TAS Criteria 5-7 Identity Theft Cases to W&I IPSU (Mar. 31, 2010). The following are examples of when TAS would continue to advocate for identity theft victims: (1) the taxpayer declines referral to the IPSU; (2) the IPSU has already tried to provide relief in the past, and has failed; (3) systemic burden cases that require advocacy which might lead to the issuance of a TAO on behalf of the taxpayer; (4) taxpayer cases added to TAMIS will remain in TAS and be resolved through the Operations Assistance Request (OAR) process; (5) taxpayers not satisfied with the assistance provided through the IPSU; (6) taxpayers being assisted by the IPSU, who subsequently face economic burden while the IPSU is processing their request when the IPSU cannot provide relief within 24 hours; (7) congressional cases; and (8) any cases previously open in TAS. Available at: <http://www.irs.gov/advocate/article/0,,id=171162,00.html>. See also TAS Interim Guidance Memorandum TAS-13.1.16-1011-011, *Interim Guidance on Referring Identity Theft Criteria 5-7 Cases to the Identity Protection Specialized Unit (IPSU)* (Oct. 18, 2011) available at <http://www.irs.gov/pub/foia/ig/tas/tas-13.1.16-1011-011.pdf>.

<sup>50</sup> IRS, *IPSU Identity Theft Report* (Oct. 2, 2010); IRS, *IPSU Identity Theft Report* (Oct. 1, 2011).

<sup>51</sup> Data obtained from TAMIS. TAS retrieved the data on the first day of the month following the end of each quarter for FY 2007 through FY 2011.

- Implementing consistent identity theft procedures across multiple IRS organizations; and
- Improving taxpayer service and identity theft case processing efficiency while managing the complex case resolution process.

The ITAAG established five teams to analyze current ID theft operations, identify the key “pain points” and quick actions to improve them, determine a future structure for improving taxpayer service and case resolution, and recommend a plan to achieve these goals.

The National Taxpayer Advocate testified before Congress in May 2011 on IRS challenges in dealing with identity theft perpetrators and victims and has discussed IDT issues in numerous reports to Congress.<sup>52</sup> TAS continues to search for ways to improve the IRS’s ability to assist victims of identity theft. In addition to assisting individual taxpayers, TAS asked all its employees to suggest improvements in IDT procedures to the ITAAG team.<sup>53</sup>

#### *Reappearance of the QRP in TAS Case Receipts*

The QRP has reappeared as a top issue in TAS casework in the form of Pre-Refund Wage Verification Hold (PRWVH) receipts.<sup>54</sup> In FY 2011, TAS received 21,286 PRWVH cases, providing some form of relief in 75 percent of the cases closed.<sup>55</sup> Figure 4.7 shows the dramatic increase in these cases.

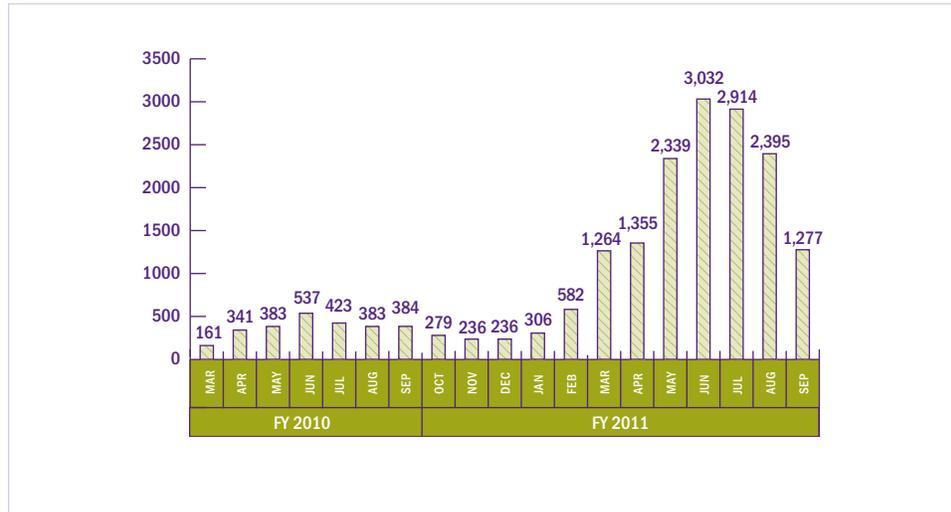
<sup>52</sup> *The Spread of Tax Fraud by Identity Theft: A Threat to Taxpayers, A Drain on the Public Treasury, Hearing Before S. Subcomm. on Fiscal Responsibility and Economic Growth, S. Comm. on Finance, 112th Congress* (Statement of Nina E. Olson, National Taxpayer Advocate) (May 25, 2011). National Taxpayer Advocate 2005 Annual Report to Congress 180-191 (Most Serious Problem: *Identity Theft*); National Taxpayer Advocate 2007 Annual Report to Congress 96-115 (Most Serious Problem: *Identity Theft Procedures*); National Taxpayer Advocate 2008 Annual Report to Congress 79-94 (Most Serious Problem: *IRS Process Improvements to Assist Victims of Identity Theft*); National Taxpayer Advocate 2009 Annual Report to Congress 307-317 (Status Update: *IRS’s Identity Theft Procedures Require Fine Tuning*); National Taxpayer Advocate FY 2012 Objectives Report to Congress 14-18 (Areas of Focus: *The IRS Needs to Improve Its Identity Theft Victim Assistance Strategy*).

<sup>53</sup> For a more detailed discussion of identity theft issues and the National Taxpayer Advocate’s concerns about how this program is being implemented, see Most Serious Problem: *Tax-Related Identity Theft Continues to Impose Significant Burden on Taxpayers and the IRS, supra*.

<sup>54</sup> See National Taxpayer Advocate 2007 Annual Report to Congress 448-458 (Status Update: *Questionable Refund Program*); National Taxpayer Advocate 2006 Annual Report to Congress 408-421 (Status Update: *Major Improvements in the Questionable Refund Program and Some Continuing Concerns*); National Taxpayer Advocate 2005 Annual Report to Congress 25-54 (Most Serious Problem: *Criminal Investigation Refund Freezes*); National Taxpayer Advocate 2003 Annual Report to Congress 175-181 (Most Serious Problem: *Criminal Investigation Freezes*).

<sup>55</sup> Data obtained from TAMIS. TAS determines relief based upon whether TAS is able to provide full or partial relief or assistance on the issue initially identified by the taxpayer.

**FIGURE 4.7, TAS Monthly Pre-Refund Wage Verification Hold Receipts, March 2010 Through September 2011<sup>56</sup>**



The civil side of the QRP is now referred to as the Accounts Management Taxpayer Assurance Program (AMTAP). To accomplish its primary goal of revenue protection, AMTAP selects questionable returns before releasing refunds and screens them electronically to verify the accuracy of the taxpayers’ wages and withholding. If this initial review cannot confirm the amounts, AMTAP employees begin a manual verification process that can take up to 13 weeks or more.<sup>57</sup> Such delays can create financial hardship for taxpayers who are awaiting legitimate refunds.

As discussed earlier in this report, in FY 2011 AMTAP’s inventory reached 690,000 cases,<sup>58</sup> due to a combination of insufficient staffing and inexperienced employees. The resulting delays are causing more taxpayers who are experiencing economic burden to come to TAS searching for their refunds. TAS has issued 210 TAOs to AMTAP during FY 2011 to help these taxpayers.<sup>59</sup>

<sup>56</sup> Data obtained from TAMIS. TAS retrieved the data on the first day following the end of each month, i.e., Oct. 1, 2011 for September 2011; for March 2010 through September 2011. TAS computed the receipts included in this table using PICs. Often TAS cases involve more than one issue and TAS tracks this data, however these are not included within this computation to avoid counting a case more than once.

<sup>57</sup> The manual verification process includes contacting the taxpayer’s employer or if directed by the employer, the payroll processing firm to verify wages and withholding. AMTAP employees will also perform research to ensure they have the employer’s current address. It takes the IRS two weeks to screen the cases and 11 weeks to verify the wages and withholding. TAS Notes for TAS-AMTAP OAR Backlog conference call (May 2, 2011). See also IRM 21.9.1.2.3(1) (Mar. 7, 2011).

<sup>58</sup> IRS Decedent Schemes conference call (Apr. 21, 2011). See Most Serious Problem: *The IRS’s Wage and Withholding Verification Procedures May Encroach on Taxpayer Rights and Delay Refund Processing*, supra.

<sup>59</sup> For a detailed discussion of TAOs, see *TAS Uses Taxpayer Assistance Orders to Advocate Effectively in Taxpayer Cases*, infra.

The problems with the AMTAP program are similar to those TAS identified when CI administered the QRP.<sup>60</sup> The National Taxpayer Advocate is concerned that systemic QRP issues harm legitimate taxpayers, and will continue to advocate for systemic change.<sup>61</sup> In the summer of 2011, the IRS convened a cross-functional team called Accelerated Revenue Assurance Program (ARAP) to explore ways to effectively combat refund fraud. TAS is participating on the ARAP team to ensure that the IRS respects taxpayer rights while endeavoring to protect Treasury revenue.

### *Policymakers Can Learn from the Implementation of the FTHBC.*

The FTHBC<sup>62</sup> was designed largely to bolster the residential real estate market during the recession and continuing economic downturn.<sup>63</sup> To claim the FTHBC, taxpayers navigated through a complex set of rules, making numerous determinations to ascertain which credit and what amount they were eligible to claim.<sup>64</sup> Further, because taxpayers are required to attach a “settlement statement” to their tax returns to substantiate eligibility for the credit, they cannot file returns electronically.<sup>65</sup>

Tax year 2011 marked the first year taxpayers had to file returns that recaptured or repaid the FTHBC. While the IRS knew for more than two years that FTHBC repayment programming was necessary, it chose not to start the programming changes until the 2011 filing season was already underway. This last-minute move prevented the IRS from properly testing the programming to identify and correct flaws. It created unnecessary burden and delays for taxpayers, essentially because the IRS failed to properly plan, implement, and communicate the recapture and repayment requirements.

Since 2009, the National Taxpayer Advocate has expressed concern over the challenges presented by complexity of the FTHBC, the complicated procedures intended to address

<sup>60</sup> See National Taxpayer Advocate 2005 Annual Report to Congress 25 (Most Serious Problem: *Criminal Investigation Refund Freezes*); National Taxpayer Advocate 2007 Annual Report to Congress 448 (Status Update: *Questionable Refund Program*).

<sup>61</sup> For a detailed discussion of the National Taxpayer Advocate’s recommendations to improve the TAP program, see Most Serious Problem: *The IRS’s Wage and Withholding Verification Procedures May Encroach on Taxpayer Rights and Delay Refund Processing*, *supra*.

<sup>62</sup> IRC § 36.

<sup>63</sup> Associated Press, *Northeast Home Sales Post 13 Pct. Annual Increase*, The New York Times (Mar. 23, 2010).

<sup>64</sup> There are different maximum credit amounts, two different eligibility phase-outs based on adjusted gross income, two different eligible statuses (first-time homebuyer and long-time resident) with special rules for military personnel, and three different effective dates with separate eligibility dates for entering into a contract and for completing the sale. There are also age limits, home purchase price limits, and related-party rules. Additionally, the \$7,500 FTHBC allowed under the Housing and Economic Recovery Act of 2008 requires repayment of the credit over 15 years. Pub. L. No. 110-289, § 3011, 122 Stat. 2654, 2888 (July 30, 2008). The FTHBC allowed under the American Recovery and Reinvestment Act of 2009 (Pub. L. No. 111-5, § 1006, 123 Stat. 115, 316 (Feb. 17, 2009)) and continued under the Worker, Homeownership, and Business Assistance Act of 2009 (Pub. L. No. 111-92, § 11, 123 Stat. 2984, 2989 (Nov. 6, 2009)), increased the credit to \$8,000 and eliminated the repayment requirement.

<sup>65</sup> See Worker, Homeownership, and Business Assistance Act of 2009, Pub. L. No. 111-92, § 11, 12(b) Stat. 2984, 2991 (Nov. 6, 2009), *amending* IRC § 36(d).

improper payments, and the IRS administration of the credit.<sup>66</sup> Figure 4.8 shows TAS FTHBC case receipts by issue category. Over the last three FYs, the FTHBC was responsible for 79,245 new cases in TAS (approximately nine percent of the total TAS case receipts for that period).

**FIGURE 4.8, TAS FTHBC Receipts by Issue Category, FY 2009 Through FY 2011<sup>67</sup>**

| Issue Category                                       | FY 2009 | FY 2010 | FY 2011 |
|--|---------|---------|---------|
| Refund Issues  | 393     | 2,633   | 1,897   |
| Document Processing Issues                           | 2,318   | 22,314  | 16,377  |
| Audit Issues   | 1,403   | 18,300  | 9,690   |
| Appeals Issues                                       | 4       | 542     | 1,011   |
| Other Issues   | 510     | 1,051   | 802     |
| Total FTHBC Cases                                    | 4,628   | 44,840  | 29,777  |
| Total TAS Case Receipts                              | 272,404 | 298,933 | 295,904 |
| Percentage of FTHBC Cases to Total TAS Case Receipts | 1.7%    | 15.0%   | 10.1%   |

All cases in TAS inventory are part of the IRS workload; they are generated in response to some IRS action or inaction, or some law that the IRS administers. This is readily apparent in TAS's large FTHBC case inventory, most of which it received because the IRS:

- Was slow to process the taxpayer's original or amended return claiming the credit;
- Found a math error when trying to process an FTHBC return; or
- Selected the return for audit.

While these issues persist in FY 2011, TAS is seeing a "natural shift" from FTHBC document processing and audit issues to cases where taxpayers want to appeal or seek reconsideration of the results of an audit.<sup>68</sup>

<sup>66</sup> See National Taxpayer Advocate 2009 Annual Report to Congress 506-509; National Taxpayer Advocate 2010 Annual Report to Congress 15-27, 513-515 (Most Serious Problem: *The IRS Mission Statement Does Not Reflect the Agency's Increasing Responsibilities for Administering Social Benefits Programs*) (Case Advocacy: *TAS Assists the IRS with the Administration of the First-Time Homebuyer Credit*); National Taxpayer Advocate Fiscal Year 2011 Objectives Report to Congress 37-43; National Taxpayer Advocate Fiscal Year 2012 Objectives Report to Congress 28-32; *Hearing on Tax Filing Season Update: Current IRS Issues, Before the S. Comm. on Finance, 111th Cong.* (statement of Nina E. Olson, National Taxpayer Advocate) (Apr. 15, 2010); *Hearing on Complexity and the Tax Gap: Making Tax Compliance Easier and Collecting What's Due, Hearing Before the S. Comm. on Finance, 112th Cong.* (statement of Nina E. Olson, National Taxpayer Advocate) (June 28, 2011).

<sup>67</sup> Data obtained from TAMIS. TAMIS is a dynamic system and TAS did not compile the statistics gathered for the issue categories for this table on the same date as the total TAS case receipts. TAS retrieved the FTHBC data by issue category on Oct. 18, 2011.

<sup>68</sup> When a taxpayer does not agree with the results of an audit, the taxpayer may request an administrative hearing or "appeal" to resolve tax controversies without having to go through litigation; should the taxpayer and IRS fail to administratively resolve the tax controversy, the taxpayer still retains the right to litigate. See IRM 8.1.1 (Oct. 23, 2007). The IRS uses the audit reconsideration process to reevaluate the results of previous audits where additional tax was assessed and remains unpaid or a tax credit was reversed. IRM 4.13.1.2 (Oct. 1, 2006). The IRS also uses the audit reconsideration process when a taxpayer disputes a Substitute for Return (SFR) assessment by filing an original delinquent return. See also IRS Publication 3598, *What You Should Know About the Audit Reconsideration Process* (Sept. 2011).

The FTHBC was available to taxpayers who entered into a written binding contract before May 1, 2010, to close on the purchase of a principal residence before July 1, 2010.<sup>69</sup> TAS expects case receipts for this issue will continue to decline, but the National Taxpayer Advocate encourages policymakers to use the “lessons learned” from the implementation of the FTHBC in future legislation. When a benefit will require up-front substantiation to reduce improper payments, policymakers should consider whether a direct spending program is a better vehicle, particularly if agencies other than the IRS have relevant expertise. Requiring taxpayers to include substantiation up-front, *e.g.*, a settlement statement for FTHBC, counters the efficiency and policy reasons for using the tax system to administer these benefits. Up-front substantiation:

- Is burdensome for the taxpayer and the IRS;
- May reduce taxpayer participation by increasing burden, thus negating a primary reason for administering a benefit through the tax code;
- Frustrates IRS efforts to meet congressionally mandated goals for e-filing; and
- Does not effectively eliminate fraud.<sup>70</sup>

***Delays in Processing Returns Claiming the Adoption Credit Are a Result of Up-Front Documentation Requirements.***

The Patient Protection and Affordable Care Act increased the maximum adoption credit from \$12,150 to \$13,170,<sup>71</sup> and made the credit fully refundable for 2010 and 2011. The eligibility rules are different for domestic, foreign, and special needs child adoptions. However, in all three categories, taxpayers claiming the credit can no longer file returns electronically because the IRS requires paper documentation with Form 8839, *Qualified Adoption Expenses*.

The IRS scrutinizes these returns because the credit is large and refundable. As in examinations of other refundable credits, the IRS holds the adoption credit portion of the refund until the audit determines whether the taxpayer is eligible for the credit.<sup>72</sup> On March 31, 2011, the IRS posted a reminder on its website for taxpayers to include the documentation.<sup>73</sup> According to the Treasury Inspector General for Tax Administration (TIGTA), “through April 28, 2011, the IRS received 72,656 individual claims for more than \$897

<sup>69</sup> IRC § 36(h)(1) and (2).

<sup>70</sup> For a more detailed discussion of special tax benefits and spending programs implemented through the tax code, see *Hearing on Complexity and the Tax Gap: Making Tax Compliance Easier and Collecting What's Due*, Hearing Before the S. Comm. on Finance, 112th Cong. (statement of Nina E. Olson, National Taxpayer Advocate) (June 28, 2011); National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, 75 -104 (*Running Social Programs Through the Tax System*); National Taxpayer Advocate 2010 Annual Report to Congress, vol. 2, 101 – 119 (*Evaluate the Administration of Tax Expenditures*).

<sup>71</sup> Pub. L. No. 111-148, § 10,909, 124 Stat. 119, 1021 (Mar. 23, 2010) (amending IRC § 23 and redesignating it as IRC § 36C). Rev. Proc. 2008-66, 2008-2 C.B. 1107.

<sup>72</sup> IRM 21.5.10.4.1.2, *Examination Refund Hold Projects*, (Mar. 16, 2011).

<sup>73</sup> IRS, *Adoptive Parents: Don't Delay Your Adoption Credit Refund*, available at <http://www.irs.gov/newsroom/article/0,,id=236883,00.html> (last visited May 27, 2011).

million in adoption credits. Of these, 42,399 (58 percent) either had no required documentation or the documentation was invalid or insufficient.<sup>74</sup>

In FY 2011, TAS has received 5,572 adoption credit cases and provided relief in 85.6 percent of the 4,160 cases closed.<sup>75</sup> In addition, TAS continues to receive submissions of potential systemic advocacy issues related to this topic. TAS identified the following concerns stemming from IRS administration of the credit:

- IRS auditors asked taxpayers to provide documentation before reviewing the information the taxpayers included with their original returns, so taxpayers who already submitted documentation had to send it twice;
- The IRS did not inform taxpayers how long it would take to audit their returns and when they could expect their refunds;
- IRS examiners were not knowledgeable about the expanded adoption credit under the Patient Protection and Affordable Care Act and how to handle the credit claimed for special needs children; and
- The hold on issuing the adoption credit portion of the refund caused financial burden for some taxpayers.

The adoption credit is another example of using the tax code to deliver social benefits requiring up-front substantiation, in the form of an adoption order or decree; or in the case of a special needs child, a copy of the state's determination of special needs.<sup>76</sup> The relief rate is significantly greater than the relief rate for all TAS cases.<sup>77</sup> As in the case of the FTHBC, the substantiation requirements eliminated the taxpayer's ability to file electronically and highlighted training and knowledge deficiencies in the manual processing of these claims.<sup>78</sup>

#### *TAS Assists Taxpayers Impacted by Receivership of the Deutch Law Firm.*

In May 2011, the California Attorney General's office contacted the National Taxpayer Advocate to seek assistance for a large number of clients impacted when the Law Firm of Roni Lynn Deutch was placed in control of a receiver, after Ms. Deutch closed the firm and surrendered her California law license.<sup>79</sup>

On August 23, 2010, the state of California filed suit against Roni Deutch, a professional corporation, and Roni Lynn Deutch, individually, (the defendants) alleging they orchestrated

<sup>74</sup> *Improper Payments in the Administration of Refundable Tax Credits, Hearing Before the H. Comm. on Oversight, 112th Cong.* (May 25, 2011) (Testimony of The Honorable J. Russell George, Treasury Inspector General for Tax Administration).

<sup>75</sup> Data obtained from TAMIS (Oct. 1, 2011).

<sup>76</sup> Notice 2010-66; 2010-2 C.B. 437.

<sup>77</sup> The FY 2011 relief rate for all TAS cases is 75.7 percent. The adoption credit case relief rate is 9.9 percent higher. Data obtained from TAMIS (Oct. 1, 2011).

<sup>78</sup> See *Policymakers Can Learn from the Implementation of the First-Time Homebuyer Credit, supra*.

<sup>79</sup> The State Bar of California website, available at <http://members.calbar.ca.gov/fal/Member/Detail/152429>.

a scheme that swindled thousands of dollars from taxpayers who had collection problems with the IRS. The complaint alleged that the defendants engaged in a scheme to cheat taxpayers, including senior citizens and the disabled, who could not afford to pay their tax debts by enticing them to engage the defendants to negotiate a resolution of their debts with the IRS. The complaint alleged the defendants falsely represented both their success rate in negotiating for clients and the type of resolution they could secure. The defendants promised, for example, to lower the amount the clients owed the IRS, eliminate accrued interest and penalties, establish a low monthly payment plan to retire the debt, or prevent the IRS from collecting it. The complaint further alleged the defendants falsely represented that they could immediately stop IRS collection actions, such as levies and wage garnishments, if clients retained the defendants.<sup>80</sup>

TAS worked with the state attorney general and the receiver to identify the taxpayers who needed immediate attention and to help all of those affected. The receiver provided TAS a full client list of 3,994 taxpayers, and another list of 928 identified as having “critical needs.”<sup>81</sup> A “triage” process is in place to screen “critical need” taxpayers and identify their problems. TAS employees throughout the country will assist these taxpayers.

To date, TAS has accepted approximately 170 “Deutch” cases resulting from direct taxpayer calls or the triage process where TAS has reached out to taxpayers that appear to have a current IRS levy, *i.e.*, a critical need.<sup>82</sup> The majority of these cases deal with collection-related issues, with approximately 35 percent of them involving an unresolved OIC. TAS has closed 124 Deutch cases with a relief rate of 66 percent.<sup>83</sup> The National Taxpayer Advocate alerted other IRS business units of this potential influx of cases and negotiated with the IRS to refrain from any automated collection activity through September 30, 2011. During the triage, TAS employees and revenue officers are working together to suspend enforcement activity on cases identified as being assigned to Field Collection, allowing the former Deutch clients time to evaluate their options and possibly seek new representation. Additionally, the IRS agreed to refrain from returning or rejecting any OICs submitted by the taxpayers, and instead will work with the taxpayers to try to perfect the offers or arrive at another resolution.

Finally, because the affected taxpayers are located nationwide, the National Taxpayer Advocate sent them a letter to educate them about the options for resolving their problems,

<sup>80</sup> Complaint filed in *The People of the State of California v. Roni Deutch, a Tax Corporation and Roni Lynn Deutch, an individual*, Docket No. 34-2010-00085933 (Sup. Ct. Cal.), available at [http://ag.ca.gov/cms\\_attachments/press/pdfs/n1978\\_complaint.pdf](http://ag.ca.gov/cms_attachments/press/pdfs/n1978_complaint.pdf).

<sup>81</sup> Data obtained from TAMIS (Nov. 4, 2011).

<sup>82</sup> *Id.*

<sup>83</sup> *Id.* TAS determines relief based on whether TAS can provide full or partial relief or assistance on the issue initially identified by the taxpayer. Because TAS frequently provides relief on issues that differ from the ones first identified, the relief rate as calculated is understated.

and provide them with numbers to reach both the IRS and TAS for assistance, as well as information about LITCs. TAS and the LITCs are ready to assist former Deutch taxpayers.<sup>84</sup>

### **TAS Uses Taxpayer Assistance Orders to Advocate Effectively in Taxpayer Cases.**

The Taxpayer Assistance Order is a powerful tool that Local Taxpayer Advocates (LTAs) can use to resolve their cases. An LTA should consider issuing a TAO in a well-developed case if the taxpayer is suffering or about to suffer a significant hardship as a result of the manner in which the internal revenue laws are being administered and the law and the facts support the relief.<sup>85</sup> The LTA may issue a TAO to order the IRS to take an action, cease an action, or refrain from taking an action;<sup>86</sup> for example, to release a levy.<sup>87</sup> The LTA may also issue a TAO to order the IRS to expedite consideration of a taxpayer's case, reconsider its determination in a case, or review the case at a higher level.<sup>88</sup>

The ability to issue a TAO ensures "that TAS can effectively resolve problems and protect taxpayer rights when the taxpayer has a significant hardship, even when the IRS disagrees or has other internal priorities."<sup>89</sup> TAS has implemented various approaches to ensure that LTAs better understand the types of cases that require TAOs. One such approach involves coordinated informal monthly discussions with all LTAs about case scenarios that may result in a TAO. These discussions help LTAs share experiences and learn more about what is necessary to resolve cases.<sup>90</sup> Increased awareness of the importance of the TAO as an advocacy tool has resulted in an increased use of TAOs over the past three FYs. TAS issued 45 TAOs in FY 2009, 95 in FY 2010, and 422 in FY 2011. Of the 422 TAOs issued in FY 2011, 407 have been resolved.<sup>91</sup> The IRS complied with 388 of these 407 TAOs, a 95 percent compliance rate.<sup>92</sup> Figure 4.9 shows the areas that generated TAOs in FY 2011 and how they were resolved.

<sup>84</sup> LITCs are independent from the IRS. Some clinics serve individuals whose income is below a certain level and who need to resolve a tax problem. These clinics provide professional representation before the IRS or courts in audits, appeals, tax collection disputes, and other issues for free or for a small fee. Some clinics provide information about taxpayer rights and responsibilities in many different languages for individuals who speak English as a second language.

<sup>85</sup> Treas. Reg. § 301.7811-1(a), 76 Fed. Reg. 18,059 (Apr. 1, 2011). See also IRC § 7811(a)(1); IRM 13.1.20.1 (Dec. 15, 2007).

<sup>86</sup> Treas. Reg. § 301.7811-1(c), 76 Fed. Reg. 18,059 (Apr. 1, 2011); IRM 13.1.20.3 (Dec. 15, 2007).

<sup>87</sup> IRC § 7811(b)(1).

<sup>88</sup> Treas. Reg. § 301.7811-1(c), 76 Fed. Reg. 18,059 (Apr. 1, 2011); IRM 13.1.20.3 (Dec. 15, 2007).

<sup>89</sup> IRM 13.1.20.2(5) (Feb. 1, 2011).

<sup>90</sup> The monthly sessions are termed *TAO Cafés*, and these discussions, equipped with moderators and a detailed agenda, allow LTAs the ability to ask questions about TAO authority under different scenarios.

<sup>91</sup> Data obtained from TAMIS (Oct. 1, 2011). TAOs resolved include TAOs that the IRS fully complied with, TAOs that were modified and the IRS complied with, and TAOs that TAS rescinded.

<sup>92</sup> Data obtained from TAMIS (Oct. 1, 2011). TAOs complied with include TAOs that the IRS fully complied with and TAOs that were modified and the IRS complied with.

**FIGURE 4.9, Taxpayer Assistance Orders Issued in FY 2011<sup>93</sup>**

| Type of Issue          | Number of TAOs Issued | Resolution   |                             |               |            |
|------------------------|-----------------------|--------------|-----------------------------|---------------|------------|
|                        |                       | IRS Complied | TAO Modified & IRS Complied | TAS Rescinded | In Process |
| Refund                 | 212                   | 200          | 2                           | 8             | 2          |
| Collection             | 57                    | 41           | 3                           | 6             | 7          |
| Document Processing    | 43                    | 40           | 1                           |               | 2          |
| Audit                  | 33                    | 31           | 1                           | 1             |            |
| Entity                 | 38                    | 34           | 1                           |               | 3          |
| Penalty                | 14                    | 10           | 1                           | 2             | 1          |
| Appeals                | 11                    | 8            | 2                           | 1             |            |
| Criminal Investigation | 5                     | 4            |                             | 1             |            |
| Other                  | 9                     | 9            |                             |               |            |
| <b>Total</b>           | <b>422</b>            | <b>377</b>   | <b>11</b>                   | <b>19</b>     | <b>15</b>  |

**TAS's Strategy for Future Case Receipts**

TAS's case receipts have grown substantially, from 247,839 in FY 2007 to 295,904 in FY 2011, an increase of more than 19 percent.<sup>94</sup> TAS recognized the need to strategically address its rising inventories through a two-pronged approach of increased staffing and improved processes. In FY 2008, TAS began a hiring effort focused on acquiring the right mix of staffing to effectively advocate for taxpayers.<sup>95</sup> In 2010, TAS secured funds for and began development of the Taxpayer Advocate Service Integrated System (TASIS) to update and replace its current information systems.<sup>96</sup>

Even with this two-pronged approach, it has become clear that in the current federal budget environment TAS will not have the resources to continue to handle its current inventory levels without adverse impact on its ability to provide effective and timely service. TAS is a scarce resource and, as such, must continue to provide effective service to those taxpayers who need our help or to whom TAS is best suited to assist.

TAS carefully analyzed its case inventory for instances where TAS involvement and advocacy efforts are minimal, focusing on areas where:

- TAS does not have the statutory or delegated authority to resolve an issue and must ask the IRS to take action to resolve the case;
- The taxpayer is not suffering an economic burden; or

<sup>93</sup> Data obtained from TAMIS (Oct. 1, 2011).

<sup>94</sup> Data obtained from TAMIS (Oct. 1, 2007; Oct. 1, 2011).

<sup>95</sup> For additional information concerning TAS's hiring efforts, see National Taxpayer Advocate Fiscal Year 2011 Objectives Report to Congress 73-76.

<sup>96</sup> See National Taxpayer Advocate Fiscal Year 2012 Objectives Report to Congress 69-73 (*Integrated Technology: TASIS*).

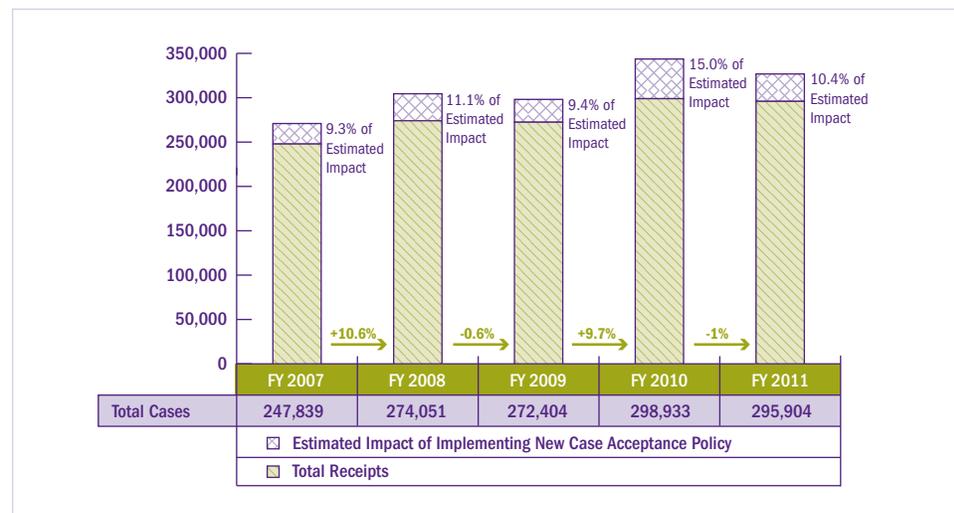
- The IRS frequently resolves the taxpayer’s issue before TAS is able to contact the IRS for case resolution.

Beginning October 1, 2011, TAS generally will not accept inquiries from taxpayers experiencing a systemic burden *solely* relating to the processing of an original return, an unpostable or rejected return,<sup>97</sup> the processing of an amended return, or the processing of an injured spouse claim.<sup>98</sup> TAS will, however, continue to accept cases for these categories where:

- The taxpayer is experiencing an economic burden or the issue involves equitable treatment or taxpayer rights;
- The issue is complex and involves more than simply processing a return, *i.e.*, the taxpayer is filing an amended return to resolve an ongoing collection issue; or
- TAS received the case from a congressional office.

Figure 4.10 illustrates how TAS’s receipts could have been reduced in the past five FYs if this policy had been in place.<sup>99</sup>

**FIGURE 4.10, TAS Case Receipts, FY 2007 – FY 2011 and Potential Impact of Implementation of Case Acceptance Policy<sup>100</sup>**



<sup>97</sup> Each account transaction is subjected to a series of validity checks prior to posting to the Master File. A transaction is termed unpostable when it fails to pass any of the validity checks and is then returned to the campus (Rejects Function) for follow-up action(s). IRM 21.5.5.2 (Oct. 1, 2007).

<sup>98</sup> TAS’s role in these types of situations is typically limited to issuing an OAR to the appropriate IRS function to advocate for resolution of the taxpayer’s problem, providing updates to taxpayers, and looking for patterns of delay to identify systemic problems. See TAS Interim Guidance Memorandum TAS-13.1.7-0911-014, *Interim Guidance on Changes to Case-Acceptance Criteria* (Sept. 1, 2011) available at [http://www.irs.gov/pub/foia/ig/tas/tas\\_13.1.7-0911-014.pdf](http://www.irs.gov/pub/foia/ig/tas/tas_13.1.7-0911-014.pdf).

<sup>99</sup> The estimated reduction in TAS workload is overstated. It does not take into account complex cases (defined above) or cases received from a congressional office.

<sup>100</sup> Data obtained from TAMIS. TAS retrieved the data on the first day following the end of the FY for FY 2007 through FY 2011.

During the coming year, we will continue to prioritize cases to ensure we can provide effective service to taxpayers who most need our assistance or whom TAS is best suited to assist.

### Congressional Case Trends

TAS is responsible for responding to certain tax account inquiries sent to the IRS by members of Congress. As shown in Figure 4.11, document processing, audit, and collection-related issues made up the top three categories of congressional inquiries in 2011.

**FIGURE 4.11, Issues In Congressional Cases, FY 2010 – FY 2011<sup>101</sup>**

| Issue Category                           | FY 2010       | FY 2011       | Percentage Change |
|--|---------------|---------------|-------------------|
| Audit Issues                             | 3,244         | 3,111         | -4.1%             |
| Document Processing Issues               | 3,451         | 2,623         | -24.0%            |
| Collection Issues                        | 3,009         | 2,779         | -7.6%             |
| Refund Issues                            | 1,778         | 1,568         | -11.8%            |
| Entity Issues                            | 830           | 1,625         | 95.8%             |
| Penalty Issues                           | 1,258         | 1,145         | -9.0%             |
| Technical, Procedural, or Statute Issues | 1,367         | 1,101         | -19.5%            |
| Payment or Credit Issues                 | 335           | 397           | 18.5%             |
| Appeals Issues                           | 278           | 267           | -4.0%             |
| Interest Issues                          | 88            | 84            | -4.6%             |
| Other Issues                             | 49            | 45            | -8.2%             |
| Criminal Investigation Issues            | 24            | 16            | -33.3%            |
| <b>Total Congressional Issues</b>        | <b>15,711</b> | <b>14,761</b> | <b>-6.1%</b>      |

Since FY 2008, congressional inquiries have continued to decline. As shown in Figure 4.12, issues relating to the Economic Stimulus Payments and FTHBC contributed significantly to TAS congressional receipts in recent years.

<sup>101</sup> Data obtained from TAMIS (Oct. 1, 2010; Oct. 1, 2011).

**FIGURE 4.12, TAS Congressional Receipts, FY 2007 - FY 2011<sup>102</sup>**

|  | FY 2007 | FY 2008 | FY 2009 | FY 2010 | FY 2011 |
|--|---------|---------|---------|---------|---------|
| Congressional Receipts   | 9,779   | 22,097  | 17,603  | 15,711  | 14,761  |
| Total Case Receipts  | 247,839 | 274,051 | 272,404 | 298,933 | 295,904 |
| % of Total Receipts  | 3.9%    | 8.1%    | 6.5%    | 5.3%    | 5.0%    |
| Congressional Receipts Related to the Economic Stimulus Payment (ESP) <sup>103</sup> |         | 10,320  | 4,264   | 127     | 22      |
| Congressional Receipts Related to FTHBC  |         |         |         | 3,243   | 2,018   |
| Adoption Credit  |         |         |         |         | 496     |

<sup>102</sup> Data obtained from TAMIS. TAS retrieved the data on the first day following the end of the FY for FY 2007 through FY 2011.

<sup>103</sup> See IRC § 6428.

## Top 25 Case Advocacy Issues for FY 2011 by TAMIS\* Receipts

| Issue Code                   | Description   | FY 2011 Cases  |
|------------------------------|---|----------------|
| 425                          | Stolen Identity   | 34,006         |
| 330                          | Processing Amended Return   | 22,743         |
| 610                          | Open Audit (Non-Revenue Protection Strategy (RPS), Earned Income Tax Credit (EITC)) | 21,397         |
| 045                          | Pre-Refund Wage Verification Hold   | 21,286         |
| 71X                          | Levies  | 15,466         |
| 315                          | Unpostable / Reject   | 13,288         |
| 620                          | Reconsideration / Substitute for Return / IRC § 6020(b) / Audit                     | 11,902         |
| 310                          | Processing Original Return  | 11,578         |
| 020                          | Expedite Refund Request   | 9,386          |
| 63X-640                      | EITC Claims / Certification / Reconsideration / Recertification                     | 8,729          |
| 340                          | Injured Spouse Claim  | 8,295          |
| 060                          | IRS Offset  | 6,995          |
| 040                          | Returned / Stopped Refunds  | 6,489          |
| 090                          | Other Refund Inquiries / Issues   | 6,135          |
| 75X                          | Installment Agreement   | 5,899          |
| 540                          | Civil Penalties other than Trust Fund Recovery Penalty                              | 5,301          |
| 675                          | Combined Annual Wage Reporting / Federal Unemployment Tax Act (CAWR-FUTA)           | 5,192          |
| 670                          | Closed Underreporter  | 5,151          |
| 72X                          | Liens   | 4,637          |
| 320                          | Math Error  | 4,471          |
| 390                          | Other Document Processing Issues  | 4,419          |
| 790                          | Other Collection Issues   | 4,267          |
| 91X                          | Appeals   | 4,056          |
| 520                          | Failure to File (FTF) / Failure to Pay (FTP) Penalty                                | 3,586          |
| 010                          | Lost / Stolen Refunds   | 3,239          |
| <b>Total Top 25 Receipts</b> |   | <b>247,913</b> |
| <b>Total TAS Receipts</b>    |   | <b>295,904</b> |

\* Taxpayer Advocate Management Information System.

## Advocacy Portfolio Advisor Assignments

| Portfolio Assignment   | Portfolio Owner | Location          | Phone Number        |
|--|-----------------|-------------------|---------------------|
| Military Issues  | Douts, K        | AK                | 907-271-6297        |
| Powers of Attorney   | Hawkins, D      | AL                | 205-912-5634        |
| Designated Federal Official (DFO) Area 5   | Wilde, B        | AR                | 501-396-5820        |
| Levies   | Wilde, B        | AR                | 501-396-5820        |
| Withholding Compliance   | Murphy, M       | AZ                | 602-636-9503        |
| Tax Forum Case Resolution Room   | Sawyer, M       | CA-Fresno         | 559-442-6418        |
| DFO Area 7   | Curran, D       | CA-LA             | 213-576-3016        |
| Tax Forum Case Resolution Room   | Adams, C        | CA-Laguna Niguel  | 949-389-4790        |
| e-Services   | Todaro, T       | CA-Oakland        | 510-637-3079        |
| Audit Reconsiderations   | Martin, T       | CA-Sacramento     | 916-974-5191        |
| Collection Statute Expiration Dates (CSEDs)  | Sherwood, T     | CO                | 303-603-4601        |
| Federal Tax Liens  | Sherwood, T     | CO                | 303-603-4601        |
| Federal Levy Payment Program (FPLP)  | Moquin, K       | CT                | 860-756-4550        |
| Employment Tax Policy  | Garvin, W       | DE                | 302-286-1545        |
| Seizure and Sales  | Crook, T        | FL-Ft. Lauderdale | 954-423-7676        |
| Examination Strategy   | Revel-Addis, B  | FL-Jacksonville   | 904-665-0523        |
| DFO Area 3   | McClendon, L    | GA-Atlanta Campus | 770-936-4543        |
| Individual Master File Information Reporting & Document Matching (Automated Underreporter) | McClendon, L    | GA-Atlanta Campus | 770-936-4543        |
| U.S. Territories & Possessions   | James, G        | HI                | 808-566-2927        |
| Health Care I (Individual)   | DeTimmerman, P  | IA                | 515-564-6880        |
| Innocent Spouse  | Knowles, J      | ID                | 208-387-2827 ex 272 |
| Health Care II (Business)  | Taylor, S       | IL-Chicago        | 312-566-3801        |
| Penalty Administration   | Bates, P        | IL-Springfield    | 217-862-6348        |
| Correspondence Exam  | Blinn, F        | IN                | 317-685-7799        |
| Identity Theft   | Johnson, D      | KY-Covington      | 859-669-4013        |
| Earned Income Tax Credit (EITC) Outreach   | Campbell, D     | KY-Louisville     | 502-572-2201        |
| Low Income Taxpayer Clinics (LITC)   | Lewis, C        | LA                | 504-558-3468        |
| LITC   | Leifeld, K      | ME                | 207-622-8577        |
| Identity Protection Specialized Unit - Identity Theft                                      | Benoit, F       | MA-Andover        | 978-247-9020        |
| IRS Training on Taxpayer Rights  | Zarrella, J     | MA-Boston         | 617-316-2625        |
| Appeals Collection Based   | Leith, J        | MD                | 410-962-8120        |
| Appeals Examination Based  | Leith, J        | MD                | 410-962-8120        |
| Individual Taxpayer Identification Number (ITIN) Outreach                                  | Blount, P       | MI                | 313-628-3664        |
| Nonfiler Strategy (Substitute for Return, Automated Substitute for Return)                 | Warren, J       | MN                | 651-312-7874        |
| Accessing Taxpayers' Files   | Todd, J         | MO-Kansas City    | 816-291-9019        |
| Undelivered Mail   | Todd, J         | MO-Kansas City    | 816-291-9019        |
| Exempt Organization Outreach   | Guinn, P        | MO-St. Louis      | 314-612-4371        |
| Disaster Response & Recovery   | Washington, J   | MS                | 601-292-4810        |
| Interest Computation Issues  | Thompson, T     | MT                | 406-441-1044        |

| Portfolio Assignment   | Portfolio Owner | Location               | Phone Number |
|--|-----------------|------------------------|--------------|
| DFO Area 2   | Juncewicz, T    | NC                     | 336-378-2141 |
| Abusive Schemes/Refund Fraud   | Kenyon, M       | ND                     | 701-237-8299 |
| Fraud/Victim Assistance  | Swantz, C       | NE                     | 402-233-7270 |
| Communications   | Simmons, M      | NH                     | 603-433-0753 |
| EITC Compliance  | Harrison, M     | NJ                     | 973-921-4376 |
| Adoption Credit  | Halker, S       | NM                     | 505-837-5522 |
| Taxpayer Compliance Behavior   | Halker, S       | NM                     | 505-837-5522 |
| Tip Reporting and Compliance   | Brooks, D       | NV                     | 702-868-5180 |
| Return Preparer Penalties  | Greene, S       | NY-Albany              | 518-427-5412 |
| DFO Area 1   | Tehrani, B      | NY-Brooklyn            | 718-488-3501 |
| Offer in Compromise  | Tehrani, B      | NY- Brooklyn           | 718-488-3501 |
| Business Master File Information Reporting and Document Matching merged (Combined Annual Wage Reporting /Federal Unemployment Tax (CAWR/FUTA)) | Morell, C       | NY-Brookhaven          | 631-654-6935 |
| Indian Tribal Governments  | Wirth, W        | NY- Buffalo            | 716-686-4820 |
| Collection/Allowable Living Expenses   | Spisak, J       | NY-Manhattan           | 212-436-1010 |
| Exempt Organizations (Application Approval Processing)   | Eyman, N        | OH-Cincinnati          | 513-263-3249 |
| Domestic Violence - Related Tax Issues   | Davis, S        | OH-Cleveland           | 216-522-8241 |
| Financially Distressed Taxpayers   | Hensley, D      | OK                     | 405-297-4139 |
| Processing Payments  | Ashurex, S      | OR                     | 503-415-7030 |
| Automated Collection System (ACS)  | Lombardo, L     | PA-Philadelphia        | 215-861-1237 |
| Bankruptcy   | Mettlen, A      | PA-Pittsburgh          | 412-395-6423 |
| Office of Professional Responsibility  | Juarez, V       | PA-Philadelphia Campus | 267-941-2357 |
| International Taxpayers  | Vargas, C       | Puerto Rico            | 787-622-8950 |
| Practitioner Priority Services   | Szargowicz, L   | RI                     | 401-528-1916 |
| Math Error   | Sonier, G       | SC                     | 803-765-5300 |
| Farm Income & Taxation   | Gilchrist, L    | SD                     | 605-377-1606 |
| DFO Area 4   | Wess, D         | TN-Memphis             | 901-395-1700 |
| Accounts Management Taxpayer Assurance Program   | Wess, D         | TN- Memphis            | 901-395-1700 |
| Electronic Tax Administration  | Martin, B       | TN-Nashville           | 615-250-6015 |
| ITIN Processing  | Farthing, N     | TX-Austin Campus       | 512-460-4652 |
| Multilingual Initiatives   | Rolon, J        | TX-Austin              | 512-499-5970 |
| Amended Returns  | Martinez, G     | TX-Dallas              | 214-413-6520 |
| First-Time Homebuyer Credit  | Lucas, D        | TX-Houston             | 713-209-4781 |
| Customer Account Data Services (CADE)  | Logan, A        | UT-Salt Lake City      | 801-799-6962 |
| DFO Area 6   | Logan, A        | UT- Salt Lake City     | 801-799-6962 |
| Trust Fund Recovery Penalty (TFRP)   | Campbell, M     | VA                     | 804-916-3500 |
| DFO Area 1   | Fett, R         | VT                     | 802-859-1056 |
| Taxpayer Assistance Centers  | Mezger, W       | WA                     | 206-220-5704 |
| Returned/Stopped Refunds   | Johnson, B      | WI                     | 414-231-2391 |
| Injured Spouse   | Post, T         | WV                     | 304-420-8659 |
| Installment Agreement Processing   | Hough, C        | WY                     | 307-633-0881 |

**Table 1** Summons Enforcement Under IRC §§ 7602, 7604, and 7609

| Case Citation   | Issue(s)   | Pro Se | Decision |
|---|--|--------|----------|
| <b>Individual Taxpayers (But Not Sole Proprietorships)</b>  |  |        |          |
| <i>Allen, U.S. v.</i> , 105 A.F.T.R.2d (RIA) 2847 (S.D. Ohio 2010), adopting 105 A.F.T.R.2d (RIA) 887 (S.D. Ohio 2009), appeal docketed, No. 10-3782 (6th Cir. June 28, 2010) | Powell requirements satisfied; TP's jurisdictional challenges and other claims dismissed as frivolous  | Yes    | IRS      |
| <i>Allen, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 2328 (S.D. Miss. 2011), adopted by 107 A.F.T.R.2d (RIA) 2329 (S.D. Miss. 2011)   | Powell requirements satisfied  | Yes    | IRS      |
| <i>Allen, U.S. v.</i> , 2011 U.S. Dist. LEXIS 55509 (S.D. Miss. 2011), adopted by 107 A.F.T.R.2d (RIA) 2311 (S.D. Miss. 2011)   | Powell requirements satisfied  | Yes    | IRS      |
| <i>Angerami, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 1637 (D.N.H. 2011), adopted by 2011 U.S. Dist. LEXIS 31705 (D.N.H. 2011)  | Powell requirements satisfied; costs awarded to government   | Yes    | IRS      |
| <i>Barton, U.S. v.</i> , 2010 U.S. Dist. LEXIS 64860 (D.N.H. 2010), adopted by 2010 U.S. Dist. LEXIS 64731 (D.N.H. 2010)  | Powell requirements satisfied; costs awarded to government   | Yes    | IRS      |
| <i>Barton, U.S. v.</i> , 2010 U.S. Dist. LEXIS 97884 (D.N.H. 2010), adopted by 2010 U.S. Dist. LEXIS 97937 (D.N.H. 2010)  | Powell requirements satisfied; costs awarded to government   | Yes    | IRS      |
| <i>Beeman, U.S. v.</i> , 388 Fed. Appx. 82 (3d Cir. 2010) (per curiam), aff'g 105 A.F.T.R.2d (RIA) 1137 (W.D. Pa. 2010)   | District court's summons enforcement order affirmed  | Yes    | IRS      |
| <i>Bilan v. U.S.</i> , 107 A.F.T.R.2d (RIA) 1182 (N.D. Cal. 2011)   | TP's motion to quash third-party summons stayed to allow TP to respond to alleged defects in jurisdiction and service of process   | Yes    | TP       |
| <i>Bright, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 5206 (D. Haw. 2010), adopting with modifications 106 A.F.T.R.2d (RIA) 5230 (D. Haw. 2010)                                       | Civil contempt upheld; sanctions reduced   | No     | IRS      |
| <i>Brownfield, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 447 (W.D. Ky. 2011), adopting 107 A.F.T.R.2d (RIA) 446 (W.D. Ky. 2010)  | Enforcement of summons ordered   | Yes    | IRS      |
| <i>Buccilli, U.S. v.</i> , 2011 U.S. Dist. LEXIS 63005 (E.D. Mich. 2011), adopted by 2011 U.S. Dist. LEXIS 59960 (E.D. Mich. 2011)  | Powell requirements satisfied; contempt inappropriate  | Yes    | IRS      |
| <i>Buckler, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 1863 (W.D. Ky. 2011)   | TPs' (H&W) motion to quash third-party summons granted with respect to W because statute of limitations expired; denied for H  | No     | Split    |
| <i>Canatella v. U.S.</i> , 107 A.F.T.R.2d (RIA) 1690 (N.D. Cal. 2011)   | TPs' (H&W) motion to quash third-party summons denied; Powell requirements satisfied; third-party summons upheld   | Yes    | IRS      |
| <i>Carlisle, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 6534 (W.D. Mo. 2010), adopted by 106 A.F.T.R.2d (RIA) 6536 (W.D. Mo. 2010)  | Powell requirements satisfied  | Yes    | IRS      |
| <i>Cascolan, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 2282 (S.D. Cal. 2011)   | Powell requirements satisfied  | Yes    | IRS      |
| <i>Cathcart, U.S. v.</i> , 409 Fed. Appx. 74 (9th Cir. 2010), aff'g D.C. No. 2:07-cv-08395-GHK-SH (C.D. Cal. 2008)  | Summons enforcement upheld; Powell requirements satisfied; affirming authority of district court to modify summons request to permit TP to mail response; TP's bad faith argument rejected | No     | IRS      |
| <i>Cloutier, U.S. v.</i> , 2010 U.S. Dist. LEXIS 93676 (D.N.H. 2010), adopted by 2010 U.S. Dist. LEXIS 93674 (D.N.H. 2010)  | Powell requirements satisfied; costs awarded to government   | Yes    | IRS      |
| <i>Condon, U.S. v.</i> , 2011 U.S. Dist. LEXIS 8867 (D.N.H. 2011), adopted by 2011 U.S. Dist. LEXIS 9311 (D.N.H. 2011)  | Powell requirements satisfied; costs awarded to government   | Yes    | IRS      |
| <i>Cotterman v. U.S. IRS</i> , 2010 U.S. Dist. LEXIS 73707 (D. Minn. 2010), adopting 2010 U.S. Dist. LEXIS 73730 (D. Minn. 2010)  | TP's motion to quash summons dismissed; TP lacked standing to quash summons issued against him personally under I.R.C. section 7602  | Yes    | IRS      |
| <i>Cryer, U.S. v.</i> , 105 A.F.T.R.2d (RIA) 2949 (W.D. La. 2010), adopting 105 A.F.T.R.2d (RIA) 2946 (W.D. La. 2010)   | Powell requirements satisfied; TP's Fifth Amendment objection lacked merit   | Yes    | IRS      |

Table 1: Summons Enforcement Under IRC §§ 7602, 7604, and 7609

| Case Citation   | Issue(s)  | Pro Se | Decision |
|---|---|--------|----------|
| <i>Cunningham, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 6341 (S.D. Cal. 2010), later proceeding at 107 A.F.T.R.2d (RIA) 382 (S.D. Cal. 2011) appeal dismissed No. 10-56784 (9th Cir. Aug. 29, 2011) | <i>Powell</i> requirements satisfied  | Yes    | IRS      |
| <i>Deems v. U.S.</i> , 2010 U.S. Dist. LEXIS 141127 (S.D. Ga. 2010), adopted by 2011 U.S. Dist. LEXIS 11706 (S.D. Ga. 2011)   | TP's motion to quash third-party summons dismissed for lack of subject matter jurisdiction, must be filed in district court in which third-party resides  | Yes    | IRS      |
| <i>In re: Does</i> , 107 A.F.T.R.2d (RIA) 2318 (E.D. Cal. 2011)   | Court rejected "John Doe" summons for information from state for all taxpayers transferring property for little or no consideration; request lacked requisite specificity and reasonable basis to believe TPs violated tax laws | No     | TP       |
| <i>Ellis v. Comm'r</i> , 107 A.F.T.R.2d (RIA) 1450 (S.D. Cal. 2011)   | TP's untimely motion to quash third-party summons dismissed for lack of subject matter jurisdiction   | Yes    | IRS      |
| <i>Ewing, U.S. v.</i> , 2011 U.S. Dist. LEXIS 4559 (E.D. Tex. 2011), adopting 2010 U.S. Dist. LEXIS 139910 (E.D. Tex. 2010)   | <i>Powell</i> requirements satisfied  | Yes    | IRS      |
| <i>Fabian v. Comm'r</i> , 390 Fed. Appx. 250, (4th Cir. 2010) (per curiam), aff'g 105 A.F.T.R.2d (RIA) 1848 (D. Md. 2010)   | District court did not abuse discretion or clearly err in denying TP's motion to quash third-party summons  | Yes    | IRS      |
| <i>Felt v. Van Mondfrans</i> , 106 A.F.T.R.2d (RIA) 6417 (D. Utah 2010)   | TP's untimely motion to quash third-party summons dismissed for lack of jurisdiction  | Yes    | IRS      |
| <i>Felt v. Van Mondfrans</i> , 107 A.F.T.R.2d (RIA) 621 (D. Utah 2011)  | TP's untimely motion to quash third-party summons dismissed for lack of subject matter jurisdiction   | Yes    | IRS      |
| <i>Foust v. U.S.</i> , 2010 WL 4608199 (N.D. Cal. 2010)   | TP's untimely motion to quash third-party summons dismissed for lack of subject matter jurisdiction   | Yes    | IRS      |
| <i>Foust v. U.S.</i> , 107 A.F.T.R.2d (RIA) 2178 (N.D. Cal. 2011)   | TP's untimely motion to quash third-party summons dismissed for lack of subject matter jurisdiction; <i>Powell</i> requirements satisfied; enforcement ordered  | Yes    | IRS      |
| <i>Gauthier, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 5027 (M.D. Fla. 2010), adopting 106 A.F.T.R.2d (RIA) 5026 (M.D. Fla. 2010)  | Enforcement of summons ordered  | Yes    | IRS      |
| <i>Glavin v. U.S.</i> , 2010 U.S. Dist. LEXIS 55435 (W.D. Wis. 2010)  | TP's motions to quash third-party summons dismissed; IRS agent dismissed as party to suit   | Yes    | IRS      |
| <i>Gomez, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 2338 (E.D. Cal. 2011), adopted by 107 A.F.T.R.2d (RIA) 2428 (E.D. Cal. 2011)   | <i>Powell</i> requirements satisfied  | No     | IRS      |
| <i>Hall, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 470 (E.D. Cal. 2011), adopted by 107 A.F.T.R.2d (RIA) 765 (E.D. Cal. 2011)  | <i>Powell</i> requirements satisfied  | Yes    | IRS      |
| <i>Hawpe v. U.S.</i> , 107 A.F.T.R.2d (RIA) 1194 (D. Ariz. 2011)  | TP's untimely motion to quash third-party summons dismissed for lack of subject matter jurisdiction; TP received proper notice; <i>Powell</i> requirements satisfied; third-party summons upheld                                | Yes    | IRS      |
| <i>Hensley, U.S. v.</i> , 2011 U.S. Dist. LEXIS 16333 (C.D. Cal. 2011)  | <i>Powell</i> requirements satisfied  | Yes    | IRS      |
| <i>Hernandez v. U.S.</i> , 2010 U.S. Dist. LEXIS 134153 (D. Or. 2010)   | TP's motion to quash third-party summons dismissed; TP's First Amendment objection lacked merit; <i>Powell</i> requirements satisfied; enforcement ordered  | Yes    | IRS      |
| <i>Hernandez v. U.S.</i> , 106 A.F.T.R.2d (RIA) 7387 (D. Or. 2010)  | TP's untimely motion to quash third-party summons dismissed for lack of subject matter jurisdiction; sovereign immunity was not waived  | Yes    | IRS      |
| <i>Hom, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 6419 (N.D. Cal. 2010)  | <i>Powell</i> requirements satisfied  | Yes    | IRS      |
| <i>Hudman, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 624 (S.D. Cal. 2011)  | <i>Powell</i> requirements satisfied  | Yes    | IRS      |
| <i>Jenkins, U.S. v.</i> , 105 A.F.T.R.2d (RIA) 2956 (E.D. Cal. 2010), rejected as moot by 105 A.F.T.R.2d (RIA) 2957 (E.D. Cal. 2010)  | <i>Powell</i> requirements satisfied; enforcement recommended   | Yes    | IRS      |
| <i>Johnson, U.S. v.</i> , 2010 WL 3394410 (D. Utah 2010), adopted by 2010 WL 3394408 (D. Utah 2010)   | <i>Powell</i> requirements satisfied  | No     | IRS      |
| <i>Kasian v. IRS</i> , 106 A.F.T.R.2d (RIA) 5227 (D. Ariz. 2010)  | TP's motion for TRO against IRS in third-party summons request denied   | Yes    | IRS      |
| <i>Kasian v. IRS</i> , 106 A.F.T.R.2d (RIA) 7274 (D. Ariz. 2010)  | TP's untimely motion to quash third-party summons dismissed for lack of subject matter jurisdiction; sovereign immunity was not waived  | Yes    | IRS      |

Table 1: Summons Enforcement Under IRC §§ 7602, 7604, and 7609

| Case Citation  | Issue(s)  | Pro Se | Decision |
|--|---|--------|----------|
| <i>Kern v. IRS</i> , 107 A.F.T.R.2d (RIA) 1894 (E.D. Mich. 2011), adopting 2007 U.S. Dist. LEXIS 99167 (E.D. Mich. 2007)                                 | Court adopted magistrate's recommendation; TP's motion to quash third-party summons dismissed; <i>Powell</i> requirements satisfied; third-party summons enforced   | Yes    | IRS      |
| <i>Keyes, U.S. v.</i> , 2011 U.S. Dist. LEXIS 51183 (E.D. Mich. 2011), adopted by 2011 U.S. Dist. LEXIS 51181 (E.D. Mich. 2011)                          | <i>Powell</i> requirements satisfied; contempt inappropriate  | Yes    | IRS      |
| <i>Kirkland v. IRS</i> , 106 A.F.T.R.2d (RIA) 6962 (D. Nev. 2010), adopting 106 A.F.T.R.2d (RIA) 6960 (D. Nev. 2010)                                     | Court adopted magistrate's recommendation to dismiss TP's motion to quash third-party summons; TP summons failed to establish standing and subject matter jurisdiction  | Yes    | IRS      |
| <i>Kwolek v. U.S.</i> , 107 A.F.T.R.2d (RIA) 1521 (W.D. Pa. 2011)  | TP's motion to quash summons dismissed for lack of personal jurisdiction; IRS did not receive proper service of process   | No     | IRS      |
| <i>Lahasky v. U.S.</i> , 2010 WL 2671803 (E.D.N.Y. 2010)   | TP's motion to quash third-party summons dismissed; <i>Powell</i> requirements satisfied; enforcement ordered   | Yes    | IRS      |
| <i>Lanoie, U.S./IRS v.</i> , 403 Fed. Appx. 328, (10th Cir. 2010), aff'g 106 A.F.T.R.2d (RIA) 7213 (D.N.M. 2010)   | Summons enforcement upheld; <i>Powell</i> requirements satisfied; TP's Fifth Amendment challenge to summons rejected for lack of specificity; TP not entitled to <i>in camera</i> review of documents   | Yes    | IRS      |
| <i>Lavery, U.S. v.</i> , 2011 U.S. Dist. LEXIS 12970 (D.N.H. 2011), adopted by 2011 U.S. Dist. LEXIS 12957 (D.N.H. 2011)                                 | <i>Powell</i> requirements satisfied; costs awarded to government   | Yes    | IRS      |
| <i>Lawler, U.S. v.</i> , 400 Fed. Appx. 476, 106 A.F.T.R.2d (RIA) 6807 (11th Cir. 2010) (per curiam), aff'g DC No. 1:10-cv-00759-CAP (N.D. Ga. 2010)     | Enforcement order affirmed; TP's failure to respond or object to petition waived defenses   | No     | IRS      |
| <i>Lyons, U.S. v.</i> , 2011 U.S. Dist. LEXIS 67135 (E.D. Tex. 2011), adopted by 2011 U.S. Dist. LEXIS 67140 (E.D. Tex. 2011)                            | Enforcement of summons ordered  | Yes    | IRS      |
| <i>Manning, U.S. v.</i> , 2011 U.S. Dist. LEXIS 29386 (M.D. Fla. 2011), adopting 2011 U.S. Dist. LEXIS 29378 (M.D. Fla. 2011)                            | <i>Powell</i> requirements satisfied  | Yes    | IRS      |
| <i>Martin, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 6973 (E.D. Ky. 2010), adopted by 106 A.F.T.R.2d (RIA) 6974 (E.D. Ky. 2010)                                 | <i>Powell</i> requirements satisfied  | Yes    | IRS      |
| <i>Maxwell v. U.S.</i> , 106 A.F.T.R.2d (RIA) 5699 (M.D. Tenn. 2010)   | TP's motion to quash third-party summons dismissed; TP's objections were frivolous and without merit; enforcement ordered   | Yes    | IRS      |
| <i>Mazzaferro v. U.S.</i> , 107 A.F.T.R.2d (RIA) 910 (N.D. Cal. 2011)  | TP's motion to quash third-party summons dismissed; <i>Powell</i> requirements satisfied; enforcement ordered   | Yes    | IRS      |
| <i>McCarthy, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 5127 (W.D. Mo. 2010), adopting 106 A.F.T.R.2d (RIA) 5125 (W.D. Mo. 2010)                                 | <i>Powell</i> requirements satisfied  | Yes    | IRS      |
| <i>Melick, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 5707 (D.N.H. 2010)   | TP's motions to dismiss summons denied; enforcement ordered; costs awarded to government  | Yes    | IRS      |
| <i>Moore, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 804 (S.D. Cal. 2011)  | <i>Powell</i> requirements satisfied  | Yes    | IRS      |
| <i>Mottahedeh v. U.S.</i> , 411 Fed. Appx. 274, 107 A.F.T.R.2d (RIA) 671 (11th Cir. 2011) (per curiam), aff'g 105 A.F.T.R.2d (RIA) 2997 (S.D. Fla. 2010) | Third-party summons upheld; <i>Powell</i> requirements satisfied  | Yes    | IRS      |
| <i>Moyes v. U.S.</i> , 106 A.F.T.R.2d (RIA) 5980 (E.D. Cal. 2010)  | TP's motion to quash third-party summons dismissed; <i>Powell</i> requirements satisfied; Fourth Amendment does not protect bank records from summons; Fifth and Fourteenth Amendments inapplicable because TP not investigated for criminal charges; enforcement ordered | Yes    | IRS      |
| <i>Neal, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 806 (S.D. Cal. 2011)   | <i>Powell</i> requirements satisfied  | Yes    | IRS      |
| <i>Nguyen, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 2221 (S.D. Tex. 2011)  | TP's blanket Fifth Amendment objection denied; enforcement ordered  | No     | IRS      |
| <i>Parenteau, U.S. v.</i> , 2011 WL 1033718 (D.N.H. 2011), adopted by 2011 WL 1043368 (D.N.H. 2011)  | <i>Powell</i> requirements satisfied; costs awarded to government   | Yes    | IRS      |
| <i>Parker, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 758 (S.D. Miss. 2011), adopted by 107 A.F.T.R.2d (RIA) 759 (S.D. Miss. 2011)                               | <i>Powell</i> requirements satisfied  | Yes    | IRS      |
| <i>Parker, U.S. v.</i> , 2011 WL 1085669 (D.N.H. 2011), adopted by 2011 WL 1043369 (D.N.H. 2011)   | <i>Powell</i> requirements satisfied; court declined to award costs to government   | Yes    | IRS      |

Table 1: Summons Enforcement Under IRC §§ 7602, 7604, and 7609

| Case Citation   | Issue(s)  | Pro Se | Decision |
|---|---|--------|----------|
| <i>Poole v. U.S.</i> , 107 A.F.T.R.2d (RIA) 597 (N.D. Cal. 2011)  | TP's motion to quash third-party summons dismissed; <i>Powell</i> requirements satisfied; enforcement ordered | Yes    | IRS      |
| <i>Rayl, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 1236 (N.D. Cal. 2011)   | Enforcement of summons ordered  | Yes    | IRS      |
| <i>Reid-Bills, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 1411 (E.D. Cal. 2011), adopted by 107 A.F.T.R.2d (RIA) 1738 (E.D. Cal. 2011)                          | <i>Powell</i> requirements satisfied  | Yes    | IRS      |
| <i>Remmen, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 7032 (D. Minn. 2010), adopted by 106 A.F.T.R.2d (RIA) 7033 (D. Minn. 2010)                                | <i>Powell</i> requirements satisfied  | No     | IRS      |
| <i>Rollins, U.S. v.</i> , 2011 U.S. Dist. LEXIS 7504 (D.N.H. 2011), adopted by 2011 U.S. Dist. LEXIS 7233 (D.N.H. 2011)                                 | <i>Powell</i> requirements satisfied; costs awarded to government   | Yes    | IRS      |
| <i>Roulston, U.S. v.</i> , 2010 WL 5387637 (D.N.H. 2010), adopted by 2010 WL 5387630 (D.N.H. 2010)  | <i>Powell</i> requirements satisfied; costs awarded to government   | Yes    | IRS      |
| <i>Rossey, U.S. v.</i> , 2011 U.S. Dist. LEXIS 7677 (D.N.H. 2011), adopted by 2011 U.S. Dist. LEXIS 7825 (D.N.H. 2011)                                  | <i>Powell</i> requirements satisfied; costs awarded to government   | Yes    | IRS      |
| <i>Savage, U.S. v.</i> , 2010 U.S. Dist. LEXIS 88118 (M.D. Fla. 2010), adopted by 2010 U.S. Dist. LEXIS 88165 (M.D. Fla. 2010)                          | Court rejected IRS's petition for contempt; summons order modified  | Yes    | Split    |
| <i>Scharringhausen v. U.S.</i> , 106 A.F.T.R.2d (RIA) 5221 (S.D. Cal. 2010)   | TP's motion for reconsideration of summons enforcement order dismissed  | No     | IRS      |
| <i>Scott, U.S. v.</i> , 105 A.F.T.R.2d (RIA) 2978 (E.D. Cal. 2010), adopting 105 A.F.T.R.2d (RIA) 2622 (E.D. Cal. 2010)                                 | Enforcement of summons ordered  | Yes    | IRS      |
| <i>Senecal, U.S. v.</i> , 2011 U.S. Dist. LEXIS 64132 (D.N.H. 2011), adopted by 2011 U.S. Dist. LEXIS 63951 (D.N.H. 2011)                               | <i>Powell</i> requirements satisfied  | Yes    | IRS      |
| <i>Shadley, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 5440 (E.D. Cal. 2010)  | Court rejected IRS's petition for contempt; TP's Fifth Amendment claim is valid                               | Yes    | TP       |
| <i>Simpson, U.S. v.</i> , 2010 WL 5557053 (D.N.H. 2010), adopted by 2011 U.S. Dist. LEXIS 2360 (D.N.H. 2011)  | <i>Powell</i> requirements satisfied; costs awarded to government   | Yes    | IRS      |
| <i>Sommers, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 5070 (W.D. Mo. 2010), adopting 106 A.F.T.R.2d (RIA) 5065 (W.D. Mo. 2010)                                 | Court adopted magistrate's recommendation; summons enforced   | Yes    | IRS      |
| <i>Stevens, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 6025 (W.D. Mo. 2010), adopting 106 A.F.T.R.2d (RIA) 6024 (W.D. Mo. 2010)                                 | Court adopted magistrate's recommendation; <i>Powell</i> requirements satisfied; summons enforced             | Yes    | IRS      |
| <i>Stevenson, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 1928 (D. Minn. 2011), adopting in part, rejecting in part 2010 U.S. Dist. LEXIS 142775 (D. Minn. 2010) | IRS summons was overbroad, quashed; enforcement ordered with regard to unobjectionable questions              | No     | Split    |
| <i>Stotler, U.S. v.</i> , 105 A.F.T.R.2d (RIA) 2791 (N.D. Cal. 2010)  | Enforcement of summons ordered  | Yes    | IRS      |
| <i>Thorne, U.S. v.</i> , 2010 U.S. Dist. LEXIS 77397 (D. Minn. 2010), adopted by 2010 U.S. Dist. LEXIS 78038 (D. Minn. 2010)                            | Enforcement of summons ordered; government not awarded costs  | No     | IRS      |
| <i>Tofíga, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 2283 (S.D. Cal. 2011)   | <i>Powell</i> requirements satisfied  | Yes    | IRS      |
| <i>Udovich, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 7378 (N.D. Cal. 2010)  | <i>Powell</i> requirements satisfied  | Yes    | IRS      |
| <i>Usufy, U.S. v.</i> , 2010 U.S. Dist. LEXIS 126827 (E.D. Cal. 2010), adopted by 2011 U.S. Dist. LEXIS 8385 (E.D. Cal. 2011)                           | TP sufficiently complied with IRS summons request; petition to enforce dismissed as moot                      | Yes    | IRS      |
| <i>Utter v. U.S.</i> , 2010 U.S. Dist. LEXIS 80495 (W.D. Ark. 2010)   | Government's motion to enforce summons granted; TP's objections lacked merit                                  | Yes    | IRS      |
| <i>Walls, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 5410 (D. Minn. 2010), adopted by 106 A.F.T.R.2d (RIA) 5412 (D. Minn. 2010)                                 | <i>Powell</i> requirements satisfied; costs awarded to government   | Yes    | IRS      |
| <i>Wankel, U.S./IRS v.</i> , 2011 U.S. Dist. LEXIS 67160 (D.N.M. 2011)  | Enforcement of summons ordered  | Yes    | IRS      |
| <i>Whitehouse, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 7124 (D. Conn. 2010)  | <i>Powell</i> requirements satisfied; TP's Fourth and Fifth Amendment claims rejected                         | Yes    | IRS      |
| <i>Whitman, U.S. v.</i> , 105 A.F.T.R.2d (RIA) 2954 (E.D. Cal. 2010), adopted by 106 A.F.T.R.2d (RIA) 5302 (E.D. Cal. 2010)                             | <i>Powell</i> requirements satisfied; TP waived venue challenge by failing to file timely opposition          | Yes    | IRS      |

Table 1: Summons Enforcement Under IRC §§ 7602, 7604, and 7609

| Case Citation  | Issue(s)  | Pro Se | Decision |
|--|---|--------|----------|
| <i>Woodruff v. U.S. Dept. of Treas.</i> , 106 A.F.T.R.2d (RIA) 5105 (D. Utah 2010)   | TP's motion to quash summons denied for lack of jurisdiction  | Yes    | IRS      |
| <i>Zuloaga v. U.S.</i> , 106 A.F.T.R.2d (RIA) 7116 (S.D. Fla. 2010), <i>accepting</i> 106 A.F.T.R.2d (RIA) 7115 (S.D. Fla. 2010)                         | TP's motion to quash third-party summons dismissed for lack of personal jurisdiction; government did not receive proper service of process  | Yes    | IRS      |
| <b>Business Taxpayers (Corporations, Partnerships, Trusts, and Sole Proprietorships - Schedules C, E, F)</b>   |   |        |          |
| <i>Antonio, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 1448 (E.D. Cal. 2011), <i>adopted by</i> 107 A.F.T.R.2d (RIA) 1770 (E.D. Cal. 2011)                       | <i>Powell</i> requirements satisfied  | Yes    | IRS      |
| <i>Barton, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 352 (W.D. Mo. 2010), <i>adopted by</i> 107 A.F.T.R.2d (RIA) 355 (W.D. Mo. 2010)                            | <i>Powell</i> requirements satisfied  | Yes    | IRS      |
| <i>Bates v. U.S.</i> , 401 Fed. Appx. 247, 106 A.F.T.R.2d (RIA) 6895 (9th Cir. 2010), <i>aff'g</i> D.C. No. 2:09-cv-00817-LKK-EFB (E.D. Cal. 2010)       | District court's dismissal of TP's motions to quash was proper; sanctions imposed   | Yes    | IRS      |
| <i>Boccasini, U.S. v.</i> , 2010 U.S. Dist. LEXIS 64371 (E.D.N.Y. 2010)  | <i>Powell</i> requirements satisfied  | Yes    | IRS      |
| <i>Briggs, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 2321 (E.D. Cal. 2011), <i>adopted by</i> 2011 U.S. Dist. LEXIS 59479 (E.D. Cal. 2011)                      | <i>Powell</i> requirements satisfied  | No     | IRS      |
| <i>Burdick, U.S. v.</i> , 2011 U.S. Dist. LEXIS 37077 (M.D. Fla. 2011), <i>adopted by</i> 2011 U.S. Dist. LEXIS 37081 (M.D. Fla. 2011)                   | <i>Powell</i> requirements satisfied  | Yes    | IRS      |
| <i>Corley, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 1925 (S.D. Ala. 2011), <i>adopted by</i> 2011 U.S. Dist. LEXIS 41336 (S.D. Ala. 2011)                      | <i>Powell</i> requirements satisfied  | Yes    | IRS      |
| <i>Dadgar v. U.S.</i> , 106 A.F.T.R.2d 7421 (N.D. Cal. 2010), <i>adopted by</i> 106 A.F.T.R.2d (RIA) 7424 (N.D. Cal. 2010)                               | TP's motion to quash third-party summons dismissed; <i>Powell</i> requirements satisfied; enforcement ordered   | No     | IRS      |
| <i>Dadgar v. U.S.</i> , 2011 WL 588153 (N.D. Cal. 2011), <i>adopted by</i> 2011 WL 588152 (N.D. Cal. 2011)   | TP's untimely motion to quash third-party summons dismissed for lack of subject matter jurisdiction   | No     | IRS      |
| <i>DeOrio v. U.S.</i> , 390 Fed. Appx. 706, 106 A.F.T.R.2d (RIA) 5541 (9th Cir. 2010), <i>aff'g</i> D.C. No. 08-cv-932-CJC-ANx (C.D. Cal. 2008)          | Dismissal TP's motion to quash third-party summons for lack of subject matter jurisdiction affirmed   | Yes    | IRS      |
| <i>G.P.R.A. Corp., U.S. v.</i> , 106 A.F.T.R.2d (RIA) 6755 (S.D. Cal. 2010)  | <i>Powell</i> requirements satisfied  | No     | IRS      |
| <i>Gangi v. U.S.</i> , 107 A.F.T.R.2d 1542 (D.N.J. 2011), <i>adopting in part, rejecting in part</i> 107 A.F.T.R.2d (RIA) 1538 (D.N.J. 2010)             | <i>Powell</i> requirements satisfied with respect to TP; advance-notice requirement of Section 7602(c) not satisfied with respect to TP's businesses; motion to quash third-party summons granted in part, denied in part | No     | Split    |
| <i>Gangi v. U.S.</i> , 107 A.F.T.R.2d 1029 (D. Kan. 2011)  | TP's motion to quash third-party summons dismissed; <i>Powell</i> requirements satisfied  | No     | IRS      |
| <i>Gjerde v. U.S.</i> , 107 A.F.T.R.2d (RIA) 1798 (E.D. Cal. 2011), <i>adopted by</i> 2011 U.S. Dist. LEXIS 50793 (E.D. Cal. 2011)                       | TP's motion to quash third-party summons dismissed; <i>Powell</i> requirements satisfied; TP's motion to block access denied; attorney-client privilege does not protect bank records from IRS summons                    | Yes    | IRS      |
| <i>Health Plus Chiropractic, Inc. v. U.S.</i> , 107 A.F.T.R.2d (RIA) 2174 (M.D. Fla. 2011), <i>adopted by</i> 107 A.F.T.R.2d (RIA) 2177 (M.D. Fla. 2011) | TP's motion to quash third-party summons dismissed for lack of jurisdiction   | No     | IRS      |
| <i>Jatinder Dhillon, a Med. Corp. v. U.S.</i> , 107 A.F.T.R.2d (RIA) 1143 (N.D. Cal. 2011)   | TP's motion to quash third-party summons dismissed; <i>Powell</i> requirements satisfied  | No     | IRS      |
| <i>Lara-Davila, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 2335 (E.D. Cal. 2011), <i>adopted by</i> 2011 U.S. Dist. LEXIS 62848 (E.D. Cal. 2011)                 | <i>Powell</i> requirements satisfied  | Yes    | IRS      |
| <i>MarCon, Inc. v. U.S.</i> , 2010 U.S. Dist. LEXIS 70640 (D. Idaho 2010)  | TP's motion to stay enforcement of third-party summons denied   | No     | IRS      |
| <i>Mattoon, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 6515 (W.D. Mo. 2010), <i>adopted by</i> 106 A.F.T.R.2d (RIA) 6518 (W.D. Mo. 2010)                         | Summons enforcement ordered; that summons was issued as part of fraud investigation did not constitute bad faith  | Yes    | IRS      |

Table 1: Summons Enforcement Under IRC §§ 7602, 7604, and 7609

| Case Citation  | Issue(s)   | Pro Se | Decision |
|--|--|--------|----------|
| <i>Micosaukee Tribe of Indians of Fla. v. U.S.</i> , 730 F. Supp. 2d 1344, 106 A.F.T.R.2d (RIA) 5773 (S.D. Fla. 2010)  | Court rejected TP's arguments to quash third-party summons on grounds of tribal sovereign immunity, overbreadth, and irrelevance; remanded for hearing to determine validity of claims that IRS acted in bad faith or is already in possession of materials summoned   | No     | Split    |
| <i>Nelson v. IRS</i> , 107 A.F.T.R.2d (RIA) 403 (E.D. Pa. 2011)  | TP, as an individual, lacked standing to file motion to quash third-party summons issued against corporation   | Yes    | IRS      |
| <i>Nissan N. Am., Inc. &amp; Subsidiaries, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 348 (M.D. Tenn. 2011)  | <i>Powell</i> requirements satisfied   | No     | IRS      |
| <i>North American Commc'ns, Inc. v. U.S.</i> , 106 A.F.T.R.2d (RIA) 6955 (D.S.D. 2010), <i>adopted by</i> 106 A.F.T.R.2d (RIA) 6956 (D.S.D. 2010)  | TP's untimely motion to quash third-party summons dismissed for lack of subject matter jurisdiction; <i>Powell</i> requirements satisfied; enforcement ordered   | No     | IRS      |
| <i>Nova Ben. Plans v. Comm'r</i> , 107 A.F.T.R.2d (RIA) 719 (D. Neb. 2011)   | TP's motion to quash third-party summons dismissed; <i>Powell</i> requirements satisfied   | No     | IRS      |
| <i>Nova Ben. Plans v. Comm'r</i> , 2011 U.S. Dist. LEXIS 57018 (D. Neb. 2011)  | TP's motion to amend judgment and stay compliance with summons denied; no evidence that TP was under criminal investigation at time of court order   | No     | IRS      |
| <i>Pasadena Ref. Sys. v. U.S.</i> , 107 A.F.T.R.2d (RIA) 2300 (N.D. Tex. 2011), <i>adopted by</i> 107 A.F.T.R.2d (RIA) 2303  | TP's motion to quash third-party summons granted in part, denied in part   | No     | Split    |
| <i>Richey, U.S. v.</i> , 632 F.3d 559, 107 A.F.T.R.2d (RIA) 573 (9th Cir. 2011), <i>rev'g</i> 103 A.F.T.R.2d (RIA) 1228 (D. Idaho 2009)  | IRS did not act in bad faith in continuing efforts to enforce summons after TP's consented to deficiency assessment; contents of appraisal-work files not protected by work-product doctrine; <i>Powell</i> requirements satisfied, but remanded for district judge to perform <i>in camera</i> review to determine if attorney-client privilege applies | No     | TP       |
| <i>Roe, U.S. v.</i> , 2011 WL 1615432 (10th Cir. 2011), <i>aff'g</i> 107 A.F.T.R.2d (RIA) 2013 (D. Colo. 2010), <i>motion to stay pending appeal denied by</i> 107 A.F.T.R.2d (RIA) 2280 (D. Colo. 2010) | Summons enforcement upheld; <i>Powell</i> requirements satisfied; Court rejected TP's Fourth and Fifth Amendment arguments   | Yes    | IRS      |
| <i>Rolff, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 2336 (E.D. Cal. 2011)   | <i>Powell</i> requirements satisfied   | Yes    | IRS      |
| <i>Sears v. U.S.</i> , 392 Fed. Appx. 605, 106 A.F.T.R.2d (RIA) 5979 (9th Cir. 2010), <i>rev'g</i> D.C. No. 8:08-cv-00769-DOC-MLG (C.D. Cal.)  | District court's denial of IRS motion to dismiss TP's motion to quash reversed; identities of clients not protected by attorney-client privilege   | No     | IRS      |
| <i>Sideman &amp; Bancroft, LLP, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 1780 (N.D. Cal. 2011)   | Enforcement ordered; TP's Fifth Amendment objections rejected  | No     | IRS      |
| <i>Stiner, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 2316 (E.D. Cal. 2011), <i>adopted by</i> 2011 U.S. Dist. LEXIS 59622 (E.D. Cal. 2011)  | <i>Powell</i> requirements satisfied   | Yes    | IRS      |
| <i>Swanson Flo-Systems, Co., U.S. v.</i> , 107 A.F.T.R.2d (RIA) 2434 (D. Minn. 2011), <i>adopted by</i> 107 A.F.T.R.2d (RIA) 2438 (D. Minn. 2011)  | <i>Powell</i> requirements satisfied; costs awarded to government  | No     | IRS      |
| <i>Trenk, U.S. v.</i> , 385 Fed. Appx. 254, 106 A.F.T.R.2d (RIA) 5073 (3d Cir. 2010)   | Order enforcing summons remanded to provide TP with hearing to argue against crime-fraud exception to attorney-client privilege  | No     | TP       |
| <i>Ursua, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 1263 (E.D. Cal. 2011)   | <i>Powell</i> requirements satisfied   | Yes    | IRS      |
| <i>Valero Energy Corp. v. U.S.</i> , 106 A.F.T.R.2d (RIA) 5690 (W.D. Tex. 2010)  | Motion to quash third-party summons denied; enforcement ordered; costs imposed, despite withdrawal of challenges mooted by TP's compliance   | No     | IRS      |
| <i>Williams v. U.S.</i> , 107 A.F.T.R.2d (RIA) 1453 (N.D. Tex. 2011)   | TP's motion to quash third-party summons dismissed for lack of subject matter jurisdiction, must be filed in district court in which third-party resides   | Yes    | IRS      |

**Table 2** Trade or Business Expenses Under IRC § 162 and Related Sections

| Case Citation  | Issue(s)  | Pro Se | Decision                                |
|--|---|--------|---|
| <b>Individual Taxpayers (But Not Sole Proprietorships)</b>   |   |        |   |
| <i>Abiog v. Comm’r</i> , T.C. Summ. Op. 2010-166   | Deductions allowed for legal and job placement fees; deductions denied for living expenses because employment was indeterminate, not temporary. Deductions allowed for school supplies to the extent of substantiation        | No     | Split                                   |
| <i>Alexander v. Comm’r</i> , T.C. Summ. Op. 2011-48  | Deductions denied for unsubstantiated unreimbursed employee expenses; deduction allowed for professional certification  | No     | Split                                   |
| <i>Arnold v. Comm’r</i> , T.C. Memo. 2010-223  | Deductions denied for personal use of automobile; deduction allowed for job search expenses to the extent of substantiation subject to IRC § 67(a)  | No     | Split                                   |
| <i>Brookshire v. Comm’r</i> , T.C. Memo. 2010-193  | Deductions denied for unsubstantiated expenses  | Yes    | IRS                                     |
| <i>Cook v. Comm’r</i> , T.C. Memo. 2010-137  | Deductions denied for unsubstantiated meals, cell phone, and automobile expenses  | Yes    | IRS                                     |
| <i>Davis v. Comm’r</i> , T.C. Summ. Op. 2010-89  | Expenses incurred by city employees were deductible as unreimbursed employee expenses, not ordinary and necessary business deductions   | Yes    | IRS                                     |
| <i>De Werff v. Comm’r</i> , T.C. Summ. Op. 2011-29   | Deductions denied for unsubstantiated expenses with no apparent business purpose  | Yes    | IRS                                     |
| <i>Deltoro v. Comm’r</i> , T.C. Summ. Op. 2010-123   | Deduction denied for travel and living expenses because TP did not need to stay away from home and employment was indeterminate, not temporary  | Yes    | IRS                                     |
| <i>Forrest v. Comm’r</i> , T.C. Memo. 2010-263   | Deductions allowed for meals; deductions denied for unsubstantiated phone, legal, and automobile expenses   | Yes    | Split                                   |
| <i>Gregoline v. Comm’r</i> , T.C. Summ. Op. 2010-112   | Deductions denied for unsubstantiated travel expenses   | Yes    | IRS                                     |
| <i>Groat v. Comm’r</i> , T.C. Summ. Op. 2010-154   | Deduction denied for legal fees because they were not stemming from an income-producing activity; deductions denied for telephone and postal expenses personal in nature and unsubstantiated cell phone and internet expenses | Yes    | IRS                                     |
| <i>Hamper v. Comm’r</i> , T.C. Summ. Op. 2011-17   | Deductions allowed for legal and professional fees, deductions denied for other unsubstantiated and inherently personal expenses  | Yes    | Split                                   |
| <i>Hartman v. Comm’r</i> , T.C. Summ. Op. 2010-164   | Deduction allowed for special fire scene investigation clothes; other deductions denied for lack of substantiation  | Yes    | Split                                   |
| <i>Holland v. Comm’r</i> , T.C. Summ. Op. 2010-132   | Deductions denied for unsubstantiated travel expenses; deductions allowed for union dues, special clothing, and employer-substantiated travel expenses  | Yes    | Split                                   |
| <i>Igberaese v. Comm’r</i> , T.C. Memo. 2010-284   | Deductions denied for unsubstantiated and personal travel and clothing expenses   | Yes    | IRS                                     |
| <i>Javorski v. Comm’r</i> , T.C. Summ. Op. 2010-136  | Deductions allowed for money paid to store to protect taxpayer’s job and interest because it was paid to protect his business as an employee  | No     | TP                                      |
| <i>Lumaban v. Comm’r</i> , T.C. Summ. Op. 2010-169   | Deductions allowed for job placement expenses; deductions denied for unsubstantiated lump sums  | No     | Split                                   |
| <i>Madsen v. Comm’r</i> , T.C. Summ. Op. 2010-151  | Deductions allowed for all meals and travel expenses (at the federal rate) while working away from home; deductions denied for unsubstantiated incidental expenses  | Yes    | Split                                   |
| <i>Malazarte v. Comm’r</i> , T.C. Summ. Op. 2010-168   | Deductions allowed for job placement expenses to the extent substantiated; deductions denied for living expenses because employment was indeterminate, not temporary  | No     | Split                                   |
| <i>Martinez v. Comm’r</i> , T.C. Memo. 2011-34   | Deductions denied for unsubstantiated expenses  | Yes    | IRS                                     |
| <i>Pagarigan v. Comm’r</i> , T.C. Summ. Op. 2010-167   | Class expense was necessary and ordinary so deductions allowed under Cohan; other deductions denied for failure to substantiate   | No     | Split                                   |
| <i>Pendergraft v. U.S.</i> , 94 Fed. Cl. 79 (2010), <i>appeal dismissed</i> , 2011 U.S. App. LEXIS 10987 (Fed. Cir. Apr. 27, 2011) | Summary judgment denied for disputed deduction for commission fees paid in the course of TPs’ (H&W) furniture business; appeal dismissed by agreement of the parties  | No     | TP’s Motion for Summary Judgment denied |

Table 2: Trade or Business Expenses Under IRC § 162 and Related Sections

| Case Citation   | Issue(s)  | Pro Se | Decision |
|---|---|--------|----------|
| <i>Samico v. Comm’r</i> , T.C. Summ. Op. 2010-165   | Deductions allowed for legal and job placement fees; deductions denied for unnecessary and unsubstantiated laptop and some school supplies; deductions denied for living expenses because employment was indeterminate, not temporary; other deductions allowed for substantiated expenses. | No     | Split    |
| <i>Solomon v. Comm’r</i> , T.C. Memo. 2011-91   | Deductions denied for unsubstantiated automobile and miscellaneous expenses   | Yes    | IRS      |
| <i>Sullivan v. Comm’r</i> , T.C. Memo. 2010-138   | Deductions denied for unsubstantiated cell phone and automobile expenses  | Yes    | IRS      |
| <i>Summerfield v. Comm’r</i> , T.C. Summ. Op. 2010-143  | Deductions allowed after determination that TP’s tax home was Washington, DC and that some travel was deductible unreimbursed employee expenses   | No     | TP       |
| <i>Ucol-Cobaria v. Comm’r</i> , T.C. Summ. Op. 2010-162   | Deductions allowed for legal and job placement fees and union dues; deductions denied for unsubstantiated laptop and airfare expenses; deductions denied for living expenses because employment was indeterminate, not temporary  | No     | Split    |
| <i>Williams v. Comm’r</i> , T.C. Summ. Op. 2010-86  | Deductions denied for unsubstantiated unreimbursed employee expenses  | Yes    | IRS      |
| <b>Business Taxpayers (Corporations, Partnerships, Trusts, and Sole Proprietorships – Schedules C, E, F)</b>        |   |        |          |
| <i>Adams v. Comm’r</i> , T.C. Summ. Op. 2010-134  | Deductions denied for unsubstantiated automobile, travel, meals, and entertainment expenses   | Yes    | IRS      |
| <i>Alvi v. Comm’r</i> , T.C. Summ. Op. 2010-79  | Deductions denied for five activities because TP failed to prove carrying on a trade or business; deductions allowed for online retail business expenses  | Yes    | Split    |
| <i>Bangura v. Comm’r</i> , T.C. Summ. Op. 2011-23   | Deductions denied for unsubstantiated business and automobile expenses  | Yes    | IRS      |
| <i>Barajas v. Comm’r</i> , T.C. Summ. Op. 2011-2  | Deductions allowed for automobile expenses because TPs (H&W) did not need to prove 100% corroboration of expenses   | Yes    | TP       |
| <i>Bednarski v. Comm’r</i> , T.C. Summ. Op. 2010-74   | Deductions denied for unsubstantiated and commuting expenses  | Yes    | IRS      |
| <i>Blanchette v. Comm’r</i> , T.C. Summ. Op. 2011-15  | Deductions denied because TPs (H&W) did not prove carrying on a trade or business   | Yes    | IRS      |
| <i>Bosque v. Comm’r</i> , T.C. Memo. 2011-79  | Deductions denied for unsubstantiated home use and real estate expenses; deduction allowed for professional and legal expenses  | Yes    | Split    |
| <i>Brown v. Comm’r</i> , T.C. Summ. Op. 2010-97   | Deduction denied for unsubstantiated or personal automobile expenses; deductions denied for home office because TP did not show exclusive business use  | Yes    | IRS      |
| <i>Bureriu v. Comm’r</i> , T.C. Summ. Op. 2011-52   | Deductions denied for majority of home expenses because TPs (H&W) did not show exclusive business use; deductions denied for automobile expenses; deductions allowed 50% under <i>Cohan</i>   | Yes    | Split    |
| <i>Campbell v. Comm’r</i> , T.C. Memo. 2011-42  | Deductions allowed for business and rental deductions under <i>Cohan</i> ; deduction denied for unsubstantiated rental expenses   | Yes    | Split    |
| <i>Christine v. Comm’r</i> , T.C. Memo. 2010-144  | Deductions denied for unsubstantiated travel, entertainment, automobile, and laptop expenses; deductions allowed for mailing and membership expenses; deductions denied for home office because TPs (H&W) did not show exclusive business use   | Yes    | Split    |
| <i>Collins v. Comm’r</i> , T.C. Memo. 2011-37   | Deductions denied for expenses that were properly deductible in previous year; deductions denied because TPs (H&W) failed to prove carrying on a trade or business  | Yes    | IRS      |
| <i>Coury v. Comm’r</i> , T.C. Memo. 2010-132  | Deductions denied for unsubstantiated automobile and home use expenses  | Yes    | IRS      |
| <i>Dennis v. Comm’r</i> , T.C. Memo. 2010-216   | Deduction allowed for business losses because even though not successful, horse breeding activity had profit motive   | No     | TP       |
| <i>DKD Enterprises, Inc. v. Comm’r</i> , T.C. Memo. 2011-29, appeal docketed, No. 11-2526 (8th Cir. July 11, 2011). | Deductions denied for cattery operations because no profit motive and so not a trade or business  | No     | IRS      |
| <i>Daoud v. Comm’r</i> , T.C. Memo. 2010-282  | Deductions denied for unsubstantiated COG, insurance, interest, equipment, repairs, supplies, travel and entertainment and other expenses; deductions allowed for taxes to the extent substantiated; deductions allowed for lease expenses under <i>Cohan</i>                               | No     | Split    |
| <i>Dunn v. Comm’r</i> , T.C. Memo. 2010-198   | Deduction denied for personal airplane expenses   | No     | IRS      |
| <i>Ellman v. Comm’r</i> , T.C. Summ. Op. 2010-83  | Deductions denied because TP did not prove carrying on a trade or business (start up); deductions denied for unsubstantiated employee losses  | Yes    | IRS      |

Table 2: Trade or Business Expenses Under IRC § 162 and Related Sections

| Case Citation  | Issue(s)  | Pro Se | Decision                                |
|--|---|--------|---|
| <i>Epps v. Comm’r</i> , T.C. Summ. Op. 2011-7  | Deduction denied because field employee’s expenses over employer’s monthly allowance were not ordinary, reasonable, or substantiated  | Yes    | IRS                                     |
| <i>F.W. Servs., Inc. &amp; Subsidiaries v. Comm’r</i> , T.C. Memo. 2010-128                              | Reserve fund contract was not truly insurance and so not deductible   | No     | IRS                                     |
| <i>Fessey v. Comm’r</i> , T.C. Memo. 2010-191  | Deductions denied for unsubstantiated automobile, travel, meals, entertainment, and contract labor expenses, as well as credit card membership dues and depreciation  | Yes    | IRS                                     |
| <i>Forrest v. Comm’r</i> , T.C. Memo. 2011-4   | Deductions denied for expenses because TP failed to establish carrying on a trade or business (start up); deduction denied for litigation expenses which would be properly categorized as misc. itemized deductions   | Yes    | IRS                                     |
| <i>Fresenius Med. Care Holdings, Inc. v. U.S.</i> , 106 A.F.T.R.2d (RIA) 5028 (D. Mass. 2010)            | Civil damages paid to the government in settlement of a violation of the False Claims Act may not qualify for IRC § 162(a) deduction  | No     | TP’s Motion for Summary Judgment denied |
| <i>Gamblin v. Comm’r</i> , T.C. Summ. Op. 2011-8   | Deductions denied for unsubstantiated office, supplies, travel, and labor expenses; deduction allowed for a portion of home office expenses under <i>Cohan</i>  | Yes    | Split                                   |
| <i>Gittens v. Comm’r</i> , T.C. Summ. Op. 2011-47  | Deductions denied for unsubstantiated expenses  | Yes    | IRS                                     |
| <i>Griffin v. Comm’r</i> , T.C. Memo. 2010-252   | Deductions denied for unsubstantiated and personal expenses   | Yes    | IRS                                     |
| <i>Hafeez v. Comm’r</i> , T.C. Summ. Op. 2010-109  | Deductions allowed for some automobile expenses under <i>Cohan</i> ; deduction denied for unsubstantiated cell phone expenses   | Yes    | Split                                   |
| <i>Hammond v. Comm’r</i> , T.C. Summ. Op. 2011-26  | Deductions denied for unsubstantiated rent and utilities expenses   | Yes    | IRS                                     |
| <i>Helms, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 6008 (S.D. Cal. 2010)                                       | SJ granted for U.S. with regard to some unsubstantiated rent, automobile, storage, loan interest, travel and entertainment, and employment taxes; TP did not meet the for-profit motive or ownership tests for engaging in a trade or business; SJ denied for U.S. with regard to deductions for office rental expenses | No     | Split                                   |
| <i>Herrington v. Comm’r</i> , T.C. Memo. 2011-73   | Deduction allowed for money taken by abusive boyfriend from business accounts under IRC § 165 theft instead of IRC § 162 business expenses  | No     | TP                                      |
| <i>Hill v. Comm’r</i> , T.C. Memo. 2010-268  | Deductions denied for unsubstantiated or personal home furnishings, motorcycle, and legal fees  | Yes    | IRS                                     |
| <i>Hollingsworth v. Comm’r</i> , T.C. Memo. 2010-262   | Deductions denied for unsubstantiated or not ordinary or necessary expenses   | Yes    | IRS                                     |
| <i>Jarman v. Comm’r</i> , T.C. Memo. 2010-285  | Deductions denied for unsubstantiated travel expenses   | Yes    | IRS                                     |
| <i>Jenkins v. Comm’r</i> , T.C. Memo. 2010-251   | Deductions allowed for commission fees under <i>Cohan</i> ; deductions denied for unsubstantiated expenses  | Yes    | Split                                   |
| <i>Karkour v. Comm’r</i> , T.C. Memo. 2010-124   | Deductions denied for unsubstantiated expenses  | Yes    | IRS                                     |
| <i>Kuntz v. Comm’r</i> , T.C. Memo. 2011-52  | Deduction denied for personal caregiver expenses which should be properly claimed as Schedule A medical deductions; deduction partially allowed for the clerical services rendered by the caregiver   | Yes    | Split                                   |
| <i>Lang v. Comm’r</i> , T.C. Memo. 2010-152  | Deductions denied for unsubstantiated phone, automobile, internet, equipment, and travel; deduction allowed for educational materials   | Yes    | Split                                   |
| <i>Le v. Comm’r</i> , T.C. Summ. Op. 2010-94   | Deductions allowed for TPs (H&W) carrying on the trade or business of gambling  | Yes    | TP                                      |
| <i>Lewis v. Comm’r</i> , T.C. Summ. Op. 2010-156   | Deductions denied for unsubstantiated travel, meals and entertainment, personal certification classes, and outside services expenses; deductions allowed for reimbursements and referral fees under <i>Cohan</i>  | Yes    | Split                                   |
| <i>Lynch v. Comm’r</i> , T.C. Summ. Op. 2010-95  | Deductions allowed for automobile expenses to the extent substantiated; deductions denied for unsubstantiated travel, meals and entertainment, cell phone and office supplies; deductions allowed for computer and web design expenses  | Yes    | Split                                   |
| <i>MacGregor v. Comm’r</i> , T.C. Memo. 2010-187, appeal docketed, No. 11-70693 (9th Cir. Mar. 7, 2011). | Deductions denied for lack of substantiation; deductions allowed for limited substantiated business expenses  | Yes    | Split                                   |

Table 2: Trade or Business Expenses Under IRC § 162 and Related Sections

| Case Citation  | Issue(s)  | Pro Se | Decision |
|--|---|--------|----------|
| <i>Mahdavi v. Comm’r</i> , T.C. Summ. Op. 2010-178   | Deduction denied for unsubstantiated automobile expenses  | Yes    | IRS      |
| <i>Mayo v. Comm’r</i> , 136 T.C. 81 (2011)   | Deductions disallowed for excess of wagering losses as limited by IRC § 165; gambling expenses other than the cost of wagers are allowed as unlimited   | Yes    | Split    |
| <i>Media Space, Inc. v. Comm’r</i> , 135 T.C. 424 (2010), <i>appeal docketed</i> (2nd Cir. May 24, 2011).                                  | Deductions partially allowed for forbearance payments because they did not qualify as a reacquisition of stock under IRC § 162(k)   | No     | Split    |
| <i>Moore v. Comm’r</i> , T.C. Summ. Op. 2010-102   | Deductions denied for unsubstantiated automobile expenses   | Yes    | IRS      |
| <i>Moore v. Comm’r</i> , T.C. Summ. Op. 2011-51  | Deductions denied for duplicate claimed expenses; deductions denied because TP failed to prove carrying on a trade or business (going concern)  | Yes    | IRS      |
| <i>Mulcahy, Pauritsch, Salvador &amp; Co. v. Comm’r</i> , T.C. Memo. 2011-74, <i>appeal docketed</i> , No. 11-2105 (7th Cir. May 9, 2011). | Deductions denied for consulting fees because they were not paid to the shareholders, and because they were not presumptively reasonable, nor was there intent to compensate, but rather a distribution of profits; deduction denied for unsubstantiated interest payment | No     | IRS      |
| <i>Multi-Pak Corp. v. Comm’r</i> , T.C. Memo. 2010-139   | Deductions allowed for reasonable compensation and bonuses to principal; deduction denied for unreasonable compensation in one year   | No     | Split    |
| <i>Oglesby v. Comm’r</i> , T.C. Memo. 2011-93  | Deductions denied for repairs that should be capitalized under IRC § 167; deduction denied for unsubstantiated automobile expenses; deduction allowed for union dues  | Yes    | Split    |
| <i>Ognibene v. Comm’r</i> , T.C. Summ. Op. 2010-131  | Deductions denied for unsubstantiated expenses  | Yes    | IRS      |
| <i>Owens v. Comm’r</i> , T.C. Memo. 2010-265   | Deductions denied because TP failed to establish carrying on a trade or business and for lack of substantiation   | Yes    | IRS      |
| <i>Pace v. Comm’r</i> , T.C. Memo. 2010-272  | Deductions denied for unsubstantiated and personal automobile, travel, meals and entertainment, and office expenses   | Yes    | IRS      |
| <i>Paquin v. Comm’r</i> , T.C. Summ. Op. 2010-120  | Deductions denied for personal racing activity because no profit motive   | Yes    | IRS      |
| <i>Raeber v. Comm’r</i> , T.C. Memo. 2011-39   | Deductions denied for unsubstantiated expenses  | Yes    | IRS      |
| <i>Rayden v. Comm’r</i> , T.C. Memo. 2011-1  | Deduction allowed for portion of home used for business; deduction denied for rooms not exclusively used for business   | No     | Split    |
| <i>Robinson v. Comm’r</i> , T.C. Memo. 2011-99   | Deductions denied for home office because TPs (H&W) failed to show regularity of business use; deductions denied for unsubstantiated and personal cell phone, computer, automobile, travel, meals, entertainment, etc.  | Yes    | IRS      |
| <i>Rooney v. Comm’r</i> , T.C. Memo. 2011-14   | Deductions denied for unsubstantiated depreciation; deductions denied for unsubstantiated expenses  | No     | IRS      |
| <i>Rozar v. Comm’r</i> , T.C. Summ. Op. 2010-145   | Deductions denied for unsubstantiated automobile, travel, insurance, and maintenance expenses   | Yes    | IRS      |
| <i>Sada v. Comm’r</i> , T.C. Summ. Op. 2010-146  | Deduction denied because TPs (H&W) failed to establish carrying on a trade or business  | Yes    | IRS      |
| <i>Sakkis v. Comm’r</i> , T.C. Memo. 2010-256  | Deduction allowed for rental property expenses and realty investment expenses which should properly have been on Schedule E; deduction denied for unsubstantiated radio business expenses   | No     | Split    |
| <i>Sanford v. Comm’r</i> , T.C. Summ. Op. 2011-4   | Deductions for travel, lodging, meals, repair, maintenance, etc. allowed to the extent substantiated; deductions denied for unsubstantiated books and automobile use  | Yes    | Split    |
| <i>Scroggins v. Comm’r</i> , T.C. Memo. 2011-103   | Deductions denied for unsubstantiated travel, meals, and entertainment expenses   | No     | IRS      |
| <i>Shiekh v. Comm’r</i> , T.C. Memo. 2010-126  | Deductions denied for home office because TP did not show exclusive business use; deductions denied because TP failed to prove carrying on a trade or business; deduction denied for unsubstantiated personal foreign travel  | Yes    | IRS      |
| <i>Shpilrain v. Comm’r</i> , T.C. Summ. Op. 2010-133   | Deductions denied for unsubstantiated and personal travel, books, meals, and entertainment  | Yes    | IRS      |
| <i>Simon v. IRS</i> , 106 A.F.T.R.2d (RIA) 6732 (D. Neb. 2010)   | Suit allowed to move forward on basis of preliminary evidence presented regarding business use of automobile  | Yes    | TP       |
| <i>Smith v. Comm’r</i> , T.C. Summ. Op. 2010-142   | Deductions allowed to the extent of substantiation for legal, professional, and office expenses on Schedule A; deductions denied for unsubstantiated or personal travel, automobile, meals, and entertainment expenses on Schedule C                                      | Yes    | Split    |

Table 2: Trade or Business Expenses Under IRC § 162 and Related Sections

| Case Citation   | Issue(s)  | Pro Se | Decision |
|---|---|--------|----------|
| <i>Stangeland v. Comm'r</i> , T.C. Memo. 2010-185   | Deductions denied for real estate activity expenses because TP failed to establish carrying on a trade or business  | No     | IRS      |
| <i>Stenslet v. Comm'r</i> , T.C. Summ. Op. 2010-127   | Deductions denied because TPs (H&W) failed to establish carrying on a trade or business; deductions denied for living expenses incurred at TPs' tax home  | Yes    | IRS      |
| <i>Stewart v. Comm'r</i> , T.C. Memo. 2010-184  | Deductions denied for legal expenses not originating in profit-seeking activity; deductions allowed for fees, taxes, cleaning, maintenance, supplies and rent; deductions denied for travel; deductions allowed for automobile expenses to the extent substantiated | Yes    | Split    |
| <i>Stroff v. Comm'r</i> , T.C. Memo. 2011-80  | Deductions denied for unsubstantiated phone, meals and entertainment; deductions partially allowed for automobile and labor expenses under <i>Cohan</i>   | Yes    | Split    |
| <i>Stromatt v. Comm'r</i> , T.C. Summ. Op. 2011-42  | Deductions allowed for payment for services rendered because TPs (H&W) met profit motive test for carrying on a trade or business and had adequate substantiation   | Yes    | TP       |
| <i>Sword v. Comm'r</i> , T.C. Summ. Op. 2010-158  | Deduction partially denied for depreciation where TP did not own part of the item depreciated   | Yes    | IRS      |
| <i>Tarr v. Comm'r</i> , T.C. Summ. Op. 2011-28  | Deductions denied for unsubstantiated expenses  | Yes    | IRS      |
| <i>Tax Practice Management, Inc. v. Comm'r</i> , T.C. Memo. 2010-266                          | Deductions denied for unsubstantiated or personal rent, repairs, meals, and travel  | No     | IRS      |
| <i>Weekend Warrior Trailers, Inc. v. Comm'r</i> , T.C. Memo. 2011-105                         | Deductions denied for unnecessary or unreasonable management fees; deductions denied for unsubstantiated airplane and automobile expenses; accelerated depreciation denied for plane because did not meet original use test.  | No     | IRS      |
| <i>Whitaker v. Comm'r</i> , T.C. Memo. 2010-209   | Deductions denied for unsubstantiated commissions and fees, car and truck expenses, office supplies, gifts, etc.  | No     | IRS      |
| <i>Woody v. Comm'r</i> , 403 Fed. Appx. 519 (D.C. Cir. 2010), <i>aff'g</i> T.C. Memo. 2009-93 | Deductions denied for real estate activity expenses because TP failed to establish carrying on a trade or business (start up)   | No     | IRS      |
| <i>Zeng v. Comm'r</i> , T.C. Summ. Op. 2010-77  | Deductions denied for expenses that were properly deductible in previous year; deductions denied for unsubstantiated automobile, meals, and entertainment expenses; deductions allowed for substantiated travel expenses  | Yes    | Split    |
| <i>Zhang v. Comm'r</i> , T.C. Summ. Op. 2011-21   | Deductions denied for unsubstantiated foreign travel; deduction allowed for home office expenses  | Yes    | Split    |

**Table 3**      **Appeals From Collection Due Process (CDP) Hearings Under IRC §§ 6320 and 6330**

| Case Citation   | Lien or Levy | Issue(s)   | Pro Se | Decision |
|---|--------------|--|--------|----------|
| <i>Adair v. Comm’r</i> , T.C. Memo. 2011-75   | Lien         | No abuse of discretion in denying lien withdrawal  | No     | IRS      |
| <i>Allivato v. Comm’r</i> , T.C. Summ. Op. 2011-3   | Levy         | No abuse of discretion; Tax Court lacked jurisdiction to consider abatement request  | No     | IRS      |
| <i>Anson v. Comm’r</i> , T.C. Memo. 2010-119  | Levy         | Section 6330 notice sent to TP’s last known address; Dismissed for lack of jurisdiction  | Yes    | IRS      |
| <i>Appleton v. Comm’r</i> , T.C. Memo. 2010-225   | Lien         | Summary judgment for IRS granted; IRS not precluded from filing NFTL because TP’s husband’s assets were in hands of receiver   | Yes    | IRS      |
| <i>Atkins v. Comm’r</i> , T.C. Memo. 2011-12  | Levy/Lien    | Appeals Officer communication with TP constituted a hearing.   | Yes    | IRS      |
| <i>Bang v. Comm’r</i> , T.C. Summ. Op. 2011-1   | Levy         | Inability to challenge tax liability   | No     | IRS      |
| <i>Becker v. Comm’r</i> , T.C. Memo. 2010-120   | Levy         | Remanded to determine portion of subject taxes not part of bankruptcy case   | No     |          |
| <i>Berkery v. Comm’r</i> , T.C. Memo. 2011-57   | Lien         | No abuse of discretion in sustaining filing of NFTL after TP had entered into IA, nor in denying lien withdrawal   | Yes    | IRS      |
| <i>Blaga v. Comm’r</i> , T.C. Memo. 2010-170  | Levy         | No abuse of discretion in determining to proceed with collection of penalties; frivolous arguments   | Yes    | IRS      |
| <i>Brady v. Comm’r</i> , 136 T.C. No. 19 (2011), <i>appeal docketed</i> (2nd Cir. July 13, 2011)                | Levy         | TP not entitled to apply prior years’ credit to satisfy current liability  | Yes    | IRS      |
| <i>Bryant v. Comm’r</i> , 106 A.F.T.R.2d (RIA) 6735 (6th Cir. 2010), <i>aff’g</i> T.C. Memo. 2009-78            | Levy         | No abuse of discretion in applying TP’s overpayment to only most recent liability  | Yes    | IRS      |
| <i>Byk v. Comm’r</i> , T.C. Summ. Op. 2010-137  | Lien         | Insufficient evidence that Appeals Officer had verified procedural requirements had been met; remanded   | Yes    | TP       |
| <i>Chenault v. Comm’r</i> , T.C. Memo. 2011-56  | Levy         | Challenge to underlying liability  | Yes    | IRS      |
| <i>Colvin v. Comm’r</i> , T.C. Memo. 2010-235, <i>appeal docketed</i> (9th Cir. Jan. 24, 2011)                  | Levy         | Taxes were not discharged in bankruptcy; inability to challenge underlying tax liability   | Yes    | IRS      |
| <i>Costi v. Comm’r</i> , T.C. Memo. 2010-246  | Lien         | No abuse of discretion   | Yes    | IRS      |
| <i>Covington v. Comm’r</i> , T.C. Memo. 2011-32   | Lien         | No abuse of discretion in rejecting collection alternatives. Sanction \$5,000 penalty for filing petition for delay  | Yes    | IRS      |
| <i>Currier v. Comm’r</i> , T.C. Memo. 2011-113  | Levy         | No abuse of discretion in rejecting TP payment as full settlement of liabilities; no obligation to compromise liabilities  | No     | IRS      |
| <i>Dalton v. Comm’r</i> , 135 T.C. 393 (2010), <i>appeal docketed</i> (1st Cir. Oct. 12, 2011)                  | Levy         | Abuse of discretion in rejecting OIC   | No     | TP       |
| <i>Deems v. Comm’r</i> , 107 A.F.T.R.2d (RIA) 2275 (11th Cir. 2011)   | Levy         | No abuse of discretion in denying face-to-face hearing; TP didn’t provide financial information and collection alternatives; noncompliant with tax obligations               | Yes    | IRS      |
| <i>Freeman v. Comm’r</i> , T.C. Memo. 2011-38   | Lien         | The installment agreement did not justify the release of the NFTL to collect TP’s IRC 6672 penalty liability   | Yes    | IRS      |
| <i>Gillum v. Comm’r</i> , T.C. Memo. 2010-280, <i>appeal docketed</i> , No. 11-1664 (8th Cir. Mar. 22, 2011)    | Lien/Levy    | No abuse of discretion in rejecting collection alternative; criminal plea agreement and restitution do not limit tax liabilities; TP failed to provide financial information | No     | IRS      |
| <i>Golditch v. Comm’r</i> , T.C. Memo. 2010-260, <i>appeal docketed</i> , No. 11-70742 (9th Cir. Mar. 11, 2011) | Levy         | No abuse of discretion in denying TP face-to-face hearing; frivolous arguments; TP failed to provide financial information; noncompliant with tax obligations                | No     | IRS      |
| <i>Goff v. Comm’r</i> , 135 T.C. 231 (2010)   | Levy         | Bonded promissory note of TP’s husband was not payment of liability or penalties. TP was sanctioned \$15,000 for filing a frivolous petition with the court                  | Yes    | IRS      |
| <i>Gross v. Comm’r</i> , T.C. Memo. 2010-176  | Lien         | Lien attached to ERISA qualified pension plan account, even after bankruptcy discharged liability  | No     | IRS      |
| <i>Grunsted v. Comm’r</i> , 136 T.C. No. 21 (2011)  | Levy         | No abuse of discretion; frivolous arguments  | Yes    | IRS      |
| <i>Guldager v. Comm’r</i> , T.C. Summ. Op. 2010-104   | Levy         | No abuse of discretion; TP failed to propose collection alternatives   | Yes    | IRS      |
| <i>Hartman v. Comm’r</i> , 638 F.3d 248 (3d Cir. 2011)  | Levy         | No abuse of discretion; TP failed to timely submit alternative collection proposal   | Yes    | IRS      |

Table 3: Appeals From Collection Due Process (CDP) Hearings Under IRC §§ 6320 and 6330

| Case Citation   | Lien or Levy | Issue(s)   | Pro Se | Decision |
|---|--------------|--|--------|----------|
| <i>Heidermann v. Comm'r</i> , T.C. Summ. Op. 2010-155   | Levy         | No abuse of discretion; TP failed to provide documentation in support of inability to pay  | Yes    | IRS      |
| <i>Henry v. Comm'r</i> , 403 Fed. Appx. 105 (7th Cir. 2010)   | Levy         | Tax Court lacked jurisdiction to hear TP's claims related to offset; inability to challenge underlying tax liability   | Yes    | IRS      |
| <i>Hoyle v. Comm'r</i> , 136 T.C. No. 22 (2011)   | Lien         | NFTL remained in existence because period of limitations on collections suspended  | Yes    | IRS      |
| <i>Jackson v. Comm'r</i> , T.C. Memo. 2010-180  | Levy         | No abuse of discretion in denying face-to-face hearing; TP failed to provide financial information for collection alternatives to be considered  | Yes    | IRS      |
| <i>Johnson v. Comm'r</i> , 136 T.C. No. 23 (2011), <i>appeal docketed</i> (D.C. Cir. Aug. 16, 2011)                       | Lien/Levy    | No abuse of discretion in rejecting OIC, nor in delaying handling of TP's case   | No     | IRS      |
| <i>Johnson v. Comm'r</i> , T.C. Summ. Op. 2010-69   | Levy         | TP's tax liabilities not discharged in bankruptcy; inability to challenge underlying tax liability; no abuse of discretion in sending letter to stop payment                                   | Yes    | IRS      |
| <i>Kanofsky v. Comm'r</i> , 107 A.F.T.R.2d (RIA) 1901 (3d Cir. 2011), <i>aff'g</i> T.C. Memo. 2010-46                     | Levy         | No abuse of discretion for approving proposed levy; TP failed to propose collection alternatives, didn't provide financial information, and was unable to challenge underlying tax liabilities | Yes    | IRS      |
| <i>Kreisler v. Comm'r</i> , T.C. Memo. 2011-21  | Levy         | No abuse of discretion for declining to delay levy because of the prospect that the IRS's priority claim would be paid by taxpayer's bankruptcy estate   | Yes    | IRS      |
| <i>Kubon v. Comm'r</i> , T.C. Memo. 2011-41, <i>appeal docketed</i> , No. 11-71592 (9th Cir. May 16, 2011)                | Lien         | Inability to challenge underlying tax liability; IRS verified assessment; TPs failed to propose collection alternative   | Yes    | IRS      |
| <i>Kuechenmeister v. Comm'r</i> , T.C. Summ. Op. 2010-161   | Levy         | No abuse of discretion in proceeding with collection; no genuine issue as to existence or amount of liability  | Yes    | IRS      |
| <i>Leathley v. Comm'r</i> , T.C. Memo. 2010-194   | Lien         | TP's tax liabilities not discharged in bankruptcy  | No     | IRS      |
| <i>Lee v. C'mm'r</i> , T.C. Memo. 2011-112  | Lien/Levy    | Presence of compliance officer did not prevent TP from receiving hearing; no abuse of discretion in sustaining collection action; Tax Court barred from considering TP liability               | Yes    | IRS      |
| <i>Ludzack v. Comm'r</i> , T.C. Memo. 2011-111  | Levy         | No abuse of discretion in failing to consider any OIC; TP did not submit Form 656  | Yes    | IRS      |
| <i>Mahlum v. Comm'r</i> , T.C. Memo. 2010-212   | Levy         | No abuse of discretion in denying non-collectible status as alternative to levy; TP failed to provide financial information; noncompliant with tax obligations                                 | No     | IRS      |
| <i>Malone v. Comm'r</i> , T.C. Summ. Op. 2011-24  | Lien/Levy    | No abuse of discretion in denying abatement of interest, abuse of discretion in determining to proceed with collection; error as matter of law   | Yes    | Split    |
| <i>Estate of Mangiardi v. Comm'r</i> , T.C. Memo. 2011-24, <i>appeal docketed</i> , No. 11-11609 (11th Cir. Apr. 6, 2011) | Levy         | No abuse of discretion in rejecting OIC  | No     | IRS      |
| <i>Marascalco v. Comm'r</i> , 107 A.F.T.R.2d (RIA) 1600 (5th Cir. 2011), <i>aff'g</i> T.C. Memo. 2010-130                 | Lien         | No abuse of discretion in denying IA   | No     | IRS      |
| <i>Martinez v. Comm'r</i> , T.C. Memo. 2010-181   | Levy         | Inability to challenge underlying tax liability  | No     | IRS      |
| <i>Martinez v. Comm'r</i> , T.C. Summ. Op. 2010-148   | Levy         | Inability to challenge underlying tax liability  | Yes    | IRS      |
| <i>Mattina v. Comm'r</i> , T.C. Memo. 2010-127, <i>appeal docketed</i> , No. 10-73032 (9th Cir. Sept. 27, 2010)           | Levy         | Notices of deficiencies were not invalid. Sanctioned \$5,000 for filing frivolous petition.  | Yes    | IRS      |
| <i>McPeck v. Comm'r</i> , 403 Fed. Appx. 113 (8th Cir. 2010)  | Levy         | Court of Appeals held that Tax Court's dismissal was not an abuse its discretion   | Yes    | IRS      |
| <i>Miller-Wagenknecht v. Comm'r</i> , 385 Fed. Appx. 230 (3d Cir. 2010)   | Levy         | TP waived argument that IRS improperly denied face-to-face CDP hearing; sanctions imposed by Tax Court not abuse of discretion   | Yes    | IRS      |
| <i>Mostafa v. Comm'r</i> , T.C. Memo. 2010-277  | Levy         | TP did not compromise her tax liability  | Yes    | IRS      |
| <i>Murphy v. Comm'r</i> , T.C. Summ. Op. 2010-170   | Lien         | No abuse of discretion in rejecting OIC  | Yes    | IRS      |
| <i>Oman v. Comm'r</i> , T.C. Memo. 2010-276   | Levy         | Inability to challenge underlying tax liability; no abuse of discretion in denying face-to-face hearing  | Yes    | IRS      |

Table 3: Appeals From Collection Due Process (CDP) Hearings Under IRC §§ 6320 and 6330

| Case Citation  | Lien or Levy | Issue(s)  | Pro Se | Decision |
|--|--------------|---|--------|----------|
| <i>Orian v. Comm’r</i> , T.C. Memo. 2010-234   | Levy         | TPs not precluded from challenging underlying tax liability. No abuse of discretion in denying OIC or collection alternative; TPs failed to submit financial information; noncompliant with tax obligations | No     | Split    |
| <i>Oropeza v. Comm’r</i> , 402 Fed. Appx. 221 (9th Cir. 2010), <i>aff’g</i> T.C. Memo. 2008-94               | Levy         | No abuse of discretion in approving collection action   | Yes    | IRS      |
| <i>Perlman v. Comm’r</i> , T.C. Summ. Op. 2011-34  | Levy         | No abuse of discretion in denying OIC, nor in failing to consider IA; TP did not submit financial information nor propose collection alternative  | Yes    | IRS      |
| <i>Pough v. Comm’r</i> , 135 T.C. 344 (2010)   | Lien/Levy    | No abuse of discretion in denying IA; TP did not submit financial information nor written proposal. No abuse of discretion in not waiting for TP to submit written request for abatement                    | Yes    | IRS      |
| <i>Ranuio v. Comm’r</i> , T.C. Memo. 2010-178  | Levy         | No abuse of discretion in requesting financial information, nor in rejecting OIC  | No     | IRS      |
| <i>Revah v. Comm’r</i> , T.C. Memo. 2010-269, <i>appeal docketed</i> , No. 11-70211 (9th Cir. Jan. 18, 2011) | Levy         | Equitable recoupment not applicable defense to collection; no abuse of discretion in rejecting abatement request  | No     | IRS      |
| <i>Ruhaak v. Comm’r</i> , 422 Fed. Appx. 530 (7th Cir. 2011)   | Levy         | TP has no constitutional or statutory right to withhold taxes based on moral or religious objections to government expenditures   | Yes    | IRS      |
| <i>Scherman v. Comm’r</i> , T.C. Memo. 2010-135  | Lien         | No abuse of discretion in rejecting collection alternatives; TP failed to submit financial information and submit written request for abatement   | Yes    | IRS      |
| <i>Schwendeman v. Comm’r</i> , T.C. Memo. 2011-70  | Lien         | No abuse of discretion in sustaining NTFL. Future collection action purely speculative  | No     | IRS      |
| <i>Shaw v. Comm’r</i> , T.C. Memo. 2010-210  | Lien         | No abuse of discretion in rejecting TPs’ request for IA. No abuse of discretion in rejecting OIC; TPs failed to provide financial documents and submit Form 656. No abuse of discretion in sustaining NTFL  | No     | IRS      |
| <i>Sher v. Comm’r</i> , 381 Fed. Appx. 62 (2d Cir. 2010), <i>aff’g</i> T.C. Memo. 2009-86                    | Levy         | No abuse of discretion in rejecting abatement request, nor in refusing to lift penalties on liability   | Yes    | IRS      |
| <i>Slingsby v. Comm’r</i> , T.C. Memo. 2011-3  | Lien         | No abuse of discretion for proceed with lien  | Yes    | IRS      |
| <i>Springer v. Comm’r</i> , 107 A.F.T.R.2d (RIA) 1318 (10th Cir. 2011)                                       | Lien         | Dismissed for lack of jurisdiction; Determination not issued because TP did not timely request CDP hearing  | Yes    | IRS      |
| <i>Swanton v. Comm’r</i> , T.C. Memo. 2010-140   | Levy         | No abuse of discretion in denying collection alternative. TPs failed to provide financial information and propose terms of agreement  | Yes    | IRS      |
| <i>Talaska v. Comm’r</i> , T.C. Summ. Op. 2011-33  | Levy         | Inability to challenge underlying liability   | Yes    | IRS      |
| <i>Taylor v. Comm’r</i> , T.C. Memo. 2010-213  | Levy         | No abuse of discretion in denying IA; TP did not provide financial information  | Yes    | IRS      |
| <i>Thompson v. Comm’r</i> , T.C. Summ. Op. 2011-31   | Levy         | No abuse of discretion in refusing to consider IA; TP did not provide financial information. TP afforded adequate opportunity for hearing   | Yes    | IRS      |
| <i>Thornberry v. Comm’r</i> , 136 T.C. 356 (2011)  | Lien/Levy    | Tax Court had jurisdiction to review determination disregarding hearing request on the grounds that it was a frivolous request under section 6330(g)  | Yes    | Split    |
| <i>Tinnerman v. Comm’r</i> , T.C. Memo. 2010-150, <i>appeal docketed</i> (D.C. Cir. Oct. 12, 2010)           | Levy         | No abuse of discretion. Settlement Officer can rely on Form 4340 absent showing of irregularity in assessment   | No     | IRS      |
| <i>Toth v. Comm’r</i> , T.C. Memo. 2010-227, <i>appeal docketed</i> (6th Cir. Mar. 31, 2011)                 | Levy         | No abuse of discretion in denying face-to-face hearing, sustaining levy, and rejecting collection alternatives. TP failed to provide financial information; noncompliant with tax obligations               | Yes    | IRS      |
| <i>Tucker v. Comm’r</i> , T.C. Memo. 2011-67, <i>appeal docketed</i> , No. 11-1191 (D.C. Cir. May 23, 2011)  | Levy         | No abuse of discretion in rejecting OIC and insisting on partial payment IA   | No     | IRS      |
| <i>Tucker v. Comm’r</i> , 135 T.C. 114 (2010), <i>appeal docketed</i> , No. 11-1191 (D.C. Cir. May 23, 2011) | Levy         | Appeals Officers are not “appointed officers” under the Appointment Clause of the U.S. Constitution   | No     | IRS      |
| <i>Tuttle v. Comm’r</i> , 107 A.F.T.R.2d (RIA) 2288 (9th Cir. 2011)  | Levy         | Equivalent hearing correctly held in lieu of CDP hearing. Tax Court lacked jurisdiction to review results of equivalent hearing   | No     | IRS      |
| <i>Van Camp v. Comm’r</i> , 388 Fed. Appx. 706 (9th Cir. 2010)   | Levy         | Tax Court did not abuse discretion in allowing collection to proceed. Inability to challenge tax liability; present issue not raised in CDP and Tax Court hearings  | No     | IRS      |

Table 3: Appeals From Collection Due Process (CDP) Hearings Under IRC §§ 6320 and 6330

| Case Citation   | Lien or Levy | Issue(s)   | Pro Se | Decision |
|---|--------------|--|--------|----------|
| <i>Wadleigh v. Comm’r</i> , 134 T.C. 280 (2010)   | Levy         | IRS not barred from levying prepetition property excluded from bankruptcy case. Notice of levy not premature; insufficient records to determine abuse of discretion in sustaining levy | No     | IRS      |
| <i>West v. Comm’r</i> , T.C. Memo. 2010-250, appeal docketed (1st Cir. Dec. 21, 2010)                                     | Lien         | TP’s OIC received adequate consideration in prior proceeding   | Yes    | IRS      |
| <i>White v. Comm’r</i> , 385 Fed. Appx. 92 (3d Cir. 2010)   | Levy         | No abuse of discretion in denying face-to-face hearing; frivolous arguments  | Yes    | IRS      |
| <i>Williams v. Comm’r</i> , 107 A.F.T.R.2d (RIA) 2243 (9th Cir. 2011), aff’g T.C. Memo. 2009-158, and T.C. Memo. 2009-159 | Levy         | No abuse of discretion in closing CDP hearing before larger assessments made   | No     | IRS      |
| <i>Zastrow v. Comm’r</i> , T.C. Memo. 2010-215  | Lien         | Inability to challenge underlying tax liabilities. No abuse of discretion in denying face-to-face hearing, nor in rejecting collection alternatives; noncompliant with tax obligations | Yes    | IRS      |
| <i>Zelden v. Comm’r</i> , T.C. Memo. 2011-13  | Lien         | No abuse of discretion in rejecting collection alternative; noncompliant with tax obligations  | No     | IRS      |
| <i>Zigmont v. Comm’r</i> , T.C. Memo. 2010-253  | Levy         | No abuse of discretion in denying face-to-face hearing; frivolous arguments  | Yes    | IRS      |
| <b>Business</b>   |              |  |        |          |
| <i>535 Ramona, Inc. v. Comm’r</i> , 135 T.C. 353 (2010), appeal docketed, No. 10-73386 (9th Cir. Nov. 4, 2010)            | Levy         | Tax Court lacked jurisdiction to consider propriety of lien notice   | No     | IRS      |
| <i>Alessio Azzari, Inc. v. Comm’r</i> , 136 T.C. 178 (2011)   | Lien/Levy    | Abuse of discretion in denying IA; IRS’s abuse of discretion in refusing to consider subordination of NFTL led to late tax deposits  | No     | TP       |
| <i>Assured Source, Inc. v. Comm’r</i> , T.C. Memo. 2010-243   | Levy         | No abuse of discretion in refusing to consider collection alternatives; TP did not submit financial information  | No     | IRS      |
| <i>Comensoli v. Comm’r</i> , 107 A.F.T.R.2d (RIA) 2080 (6th Cir. 2011), aff’g T.C. Memo 2009-242                          | Lien/Levy    | No clear evidence that Tax Court erred in determining TP to be sole member of business entity  | No     | IRS      |
| <i>Enmed, LLC v. Comm’r</i> , T.C. Memo. 2010-136   | Lien         | No abuse of discretion; TP received notices and did not propose collection alternatives  | Yes    | IRS      |
| <i>Law Offices of Robert A. Cushman, LLC v. Comm’r</i> , T.C. Summ. Op. 2011-37   | Levy         | No abuse of discretion in conducting CDP hearing through telephone and correspondence, nor in denying IA   | No     | IRS      |

**Table 4**      **Failure to File Penalty Under IRC § 6651(A)(1)  
and Failure to Pay Estimated Tax Penalty Under IRC § 6654**

| Case Citation   | Issue(s)  | Pro Se | Decision                        |
|---|---|--------|---------------------------------|
| <b>Individual Taxpayers (But Not Sole Proprietorships)</b>  |   |        |                                 |
| <i>Ajah v. Comm'r</i> , T.C. Summ. Op. 2010-90  | 6651(a)(1); Reliance on accountant to file and obtain extension; No evidence of reasonable cause presented                              | Yes    | IRS                             |
| <i>Amesbury v. Comm'r</i> , T.C. Memo. 2010-148   | 6651(a)(1); 6654; Nonfiler; No evidence of reasonable cause or exception presented  | Yes    | IRS                             |
| <i>Asbury v. Comm'r</i> , T.C. Memo. 2011-107   | 6654; Nonfiler; No exception presented  | Yes    | IRS                             |
| <i>Avery v. Comm'r</i> , 399 Fed. Appx. 195, <i>aff'g</i> Tax Ct. No. 17315-05                                  | 6651(a)(1); Nonfiler; No evidence of reasonable cause presented   | Yes    | IRS                             |
| <i>Banister v. Comm'r</i> , 107 A.F.T.R.2d (RIA) 1156, <i>aff'g</i> T.C. Memo. 2008-201                         | 6651(a)(1); 6654; Nonfiler; No evidence of reasonable cause presented; IRS failed to meet burden of production for 6654                 | Yes    | Split (IRS 6651(a)(1), TP 6654) |
| <i>Bream v. Comm'r</i> , T.C. Summ. Op. 2010-110  | 6651(a)(1); Family death and financial setback for TP; No evidence of reasonable cause presented  | Yes    | IRS                             |
| <i>Brookshire v. Comm'r</i> , T.C. Memo. 2010-193   | 6651(a)(1); 6654; Nonfiler; No evidence of reasonable cause or exception presented  | Yes    | IRS                             |
| <i>Buckardt v. Comm'r</i> , T.C. Memo. 2010-145   | 6651(a)(1); 6654; TP reported all "zeros" on return; No evidence of reasonable cause or exception presented                             | Yes    | IRS                             |
| <i>Burchfield v. Comm'r</i> , T.C. Memo. 2011-30  | 6651(a)(1); 6654; TPs (H&W) reported "zero" wages on return; No evidence of reasonable cause or exception presented                     | Yes    | IRS                             |
| <i>Callahan v. Comm'r</i> , T.C. Memo. 2010-201   | 6651(a)(1); 6654; Nonfiler; No evidence of reasonable cause or exception presented  | Yes    | IRS                             |
| <i>Calloway v. Comm'r</i> , 135 T.C. 26 (2010), <i>appeal docketed</i> , No. 11-10395 (11th Cir. Jan. 27, 2011) | 6651(a)(1); No evidence of reasonable cause presented   | No     | IRS                             |
| <i>Cook v. Comm'r</i> , T.C. Memo. 2010-137   | 6651(a)(1); 6654; Nonfiler; No evidence of reasonable cause or exception presented  | Yes    | IRS                             |
| <i>Crouse v. Comm'r</i> , T.C. Memo. 2011-97  | 6651(a)(1); No evidence of reasonable cause presented   | Yes    | IRS                             |
| <i>Deltoro v. Comm'r</i> , T.C. Summ. Op. 2010-123  | 6651(a)(1); No evidence of reasonable cause presented   | Yes    | IRS                             |
| <i>Dickey v. Comm'r</i> , T.C. Memo. 2011-47  | 6651(a)(1); 6654; No evidence of reasonable cause or exception presented  | Yes    | IRS                             |
| <i>Forrest v. Comm'r</i> , T.C. Memo. 2010-263  | 6651(a)(1); 6654; Nonfiler; No evidence of reasonable cause or exception presented  | Yes    | IRS                             |
| <i>Gates v. Comm'r</i> , 135 T.C. 1 (2010)  | 6651(a)(1); No evidence of reasonable cause presented   | No     | IRS                             |
| <i>Glover v. Comm'r</i> , T.C. Memo. 2010-228   | 6651(a)(1); 6654; TP filed estate tax returns instead of individual tax returns; No evidence of reasonable cause or exception presented | Yes    | IRS                             |
| <i>Gregoline v. Comm'r</i> , T.C. Summ. Op. 2010-112  | 6651(a)(1); Filing date fell on a Sunday and so return was timely   | Yes    | TP                              |
| <i>Harper v. Comm'r</i> , T.C. Summ. Op. 2011-56  | 6651(a)(1); 6654; Nonfiler; No evidence of reasonable cause or exception presented  | Yes    | IRS                             |
| <i>High v. Comm'r</i> , T.C. Summ. Op. 2011-36  | 6651(a)(1); No evidence of reasonable cause presented   | Yes    | IRS                             |
| <i>Holmes v. Comm'r</i> , T.C. Memo. 2011-31  | 6651(a)(1); No evidence of reasonable cause presented   | Yes    | IRS                             |
| <i>Holmes v. Comm'r</i> , T.C. Memo. 2011-26  | 6651(a)(1); 6654; Nonfiler; Internal IRS memo received while in Iraq satisfied reasonable cause; No exception presented                 | Yes    | Split (TP 6651(a)(1), IRS 6654) |
| <i>Hyde v. Comm'r</i> , T.C. Memo. 2011-104   | 6651(a)(1); 6654; Nonfiler; No evidence of reasonable cause or exception presented  | Yes    | IRS                             |
| <i>Igberaese v. Comm'r</i> , T.C. Memo. 2010-284  | 6651(a)(1); No evidence of reasonable cause presented   | Yes    | IRS                             |
| <i>Jeanmarie v. Comm'r</i> , T.C. Memo. 2010-281  | 6651(a)(1); No evidence of reasonable cause presented   | Yes    | IRS                             |
| <i>Jones v. Comm'r</i> , T.C. Summ. Op. 2010-139  | 6651(a)(1); 6654; Incarceration and divorce from TP's spouse; No evidence of reasonable cause or exception presented                    | Yes    | IRS                             |
| <i>Mathews v. Comm'r</i> , T.C. Memo. 2010-226  | 6651(a)(1); Nonfiler; No evidence of reasonable cause presented   | Yes    | IRS                             |
| <i>O'Boyle v. Comm'r</i> , T.C. Memo. 2010-149, <i>appeal docketed</i> , No. 11-11897 (11th Cir. Apr. 25, 2011) | 6651(a)(1); 6654; No evidence of reasonable cause or exception presented  | Yes    | IRS                             |

Table 4: Failure to File Penalty Under IRC § 6651(A)(1) and Failure to Pay Estimated Tax Penalty Under IRC § 6654

| Case Citation  | Issue(s)   | Pro Se | Decision               |
|--|--|--------|------------------------|
| <i>Ohsman v. Comm’r</i> , T.C. Memo. 2011-98, <i>appeal docketed</i> , No. 11-72127 (9th Cir. July 26, 2011)                             | 6651(a)(1); TPs (H&W) not required to file disputed form so not liable for addition to tax                 | No     | TP                     |
| <i>Oliver v. Comm’r</i> , T.C. Memo. 2011-43   | 6651(a)(1); Nonfiler; No evidence of reasonable cause presented  | Yes    | IRS                    |
| <i>Oliver v. Comm’r</i> , T.C. Memo. 2011-44   | 6651(a)(1); 6654; Nonfiler; No evidence of reasonable cause or exception presented                         | Yes    | IRS                    |
| <i>Oman v. Comm’r</i> , T.C. Memo. 2010-276  | 6651(a)(1); 6654; TP reported all “zeros” on return; No evidence of reasonable cause presented             | Yes    | IRS                    |
| <i>Owusu v. Comm’r</i> , T.C. Memo. 2010-186   | 6651(a)(1); Reliance on accountant to obtain extension; No evidence of reasonable cause presented          | Yes    | IRS                    |
| <i>Palaniappan v. Comm’r</i> , T.C. Summ. Op. 2010-82  | 6651(a)(1); No evidence of reasonable cause presented  | Yes    | IRS                    |
| <i>Pennington v. Comm’r</i> , T.C. Summ. Op. 2010-144  | 6651(a)(1); TP failed to prove submission of return; No evidence of reasonable cause presented             | Yes    | IRS                    |
| <i>Pushman v. Comm’r</i> , T.C. Summ. Op. 2011-6   | 6651(a)(1); 6654; Nonfiler; No evidence of reasonable cause or exception presented                         | Yes    | IRS                    |
| <i>Rahall v. Comm’r</i> , T.C. Memo. 2011-101  | 6651(a)(1); No evidence of reasonable cause presented  | Yes    | IRS                    |
| <i>Roberts v. Comm’r</i> , T.C. Summ. Op. 2010-76  | 6651(a)(1); No evidence of reasonable cause presented  | Yes    | IRS                    |
| <i>Russell v. Comm’r</i> , T.C. Memo. 2011-81  | 6651(a)(1); Reliance on tax professional that no tax would be due was not reasonable cause for late filing | No     | IRS                    |
| <i>Sakkis v. Comm’r</i> , T.C. Memo. 2010-256  | 6654; No exception presented   | No     | IRS                    |
| <i>Smith v. Comm’r</i> , T.C. Memo. 2011-82  | 6651(a)(1); Nonfiler; No evidence of reasonable cause presented  | Yes    | IRS                    |
| <i>Sullivan v. Comm’r</i> , T.C. Memo. 2010-138  | 6651(a)(1); 6654; Nonfiler; No evidence of reasonable cause or exception presented                         | Yes    | IRS                    |
| <i>Tinnerman v. Comm’r</i> , T.C. Memo. 2010-150 <i>sustaining</i> T.C. Memo. 2006-250, <i>appeal docketed</i> (D.C. Cir. Oct. 12, 2010) | 6651(a)(1); 6654; No evidence of reasonable cause or exception presented                                   | No     | IRS                    |
| <i>Verduzco v. Comm’r</i> , T.C. Memo. 2010-278  | 6651(a)(1); 6654; Nonfiler; No evidence of reasonable cause or exception presented                         | Yes    | IRS                    |
| <i>Wheeler v. Comm’r</i> , T.C. Memo. 2010-188   | 6651(a)(1); 6654; Nonfiler; No evidence of reasonable cause or exception presented                         | Yes    | IRS                    |
| <i>White v. Comm’r</i> , 385 Fed. Appx. 95 (3d Cir. 2010) <i>aff’g</i> Tax Ct. No. 24177-08  | 6651(a)(1); 6654; Nonfiler; No evidence of reasonable cause or exception presented                         | Yes    | IRS (appeal dismissed) |
| <i>Williams v. Comm’r</i> , T.C. Summ. Op. 2010-86   | 6651(a)(1); No evidence of reasonable cause presented  | Yes    | IRS                    |
| <i>Zilberberg v. Comm’r</i> , T.C. Memo. 2011-5  | 6651(a)(1); 6654; Nonfiler; No evidence of reasonable cause or exception presented                         | Yes    | IRS                    |
| <b>Business Taxpayers (Corporations, Partnerships, Trusts, and Sole Proprietorships – Schedules C, E, F)</b>                             |  |        |                        |
| <i>Alvi v. Comm’r</i> , T.C. Summ. Op. 2010-79   | 6651(a)(1); 6654; No evidence of reasonable cause or exception presented                                   | Yes    | IRS                    |
| <i>Bangura v. Comm’r</i> , T.C. Summ. Op. 2011-23  | 6651(a)(1); No evidence of reasonable cause presented  | Yes    | IRS                    |
| <i>Campbell v. Comm’r</i> , T.C. Memo. 2011-42   | 6651(a)(1); Daughter’s illness during time in question; No evidence of reasonable cause presented          | Yes    | IRS                    |
| <i>Coury v. Comm’r</i> , T.C. Memo. 2010-132   | 6651(a)(1); Nonfiler; TP had car accidents and medical issues; No evidence of reasonable cause presented   | Yes    | IRS                    |
| <i>Eckardt v. Comm’r</i> , T.C. Summ. Op. 2011-13  | 6651(a)(1); 6654; Nonfiler; No evidence of reasonable cause or exception presented                         | Yes    | IRS                    |
| <i>Fessey v. Comm’r</i> , T.C. Memo. 2010-191  | 6651(a)(1); 6654; No evidence of reasonable cause or exception presented                                   | Yes    | IRS                    |
| <i>Garrison v. Comm’r</i> , T.C. Memo. 2010-261  | 6651(a)(1); No evidence of reasonable cause presented  | Yes    | IRS                    |
| <i>Griffin v. Comm’r</i> , T.C. Memo. 2010-252   | 6651(a)(1); No evidence of reasonable cause presented  | Yes    | IRS                    |
| <i>Hafeez v. Comm’r</i> , T.C. Summ. Op. 2010-109  | 6651(a)(1); No evidence of reasonable cause presented  | Yes    | IRS                    |
| <i>Hammond v. Comm’r</i> , T.C. Summ. Op. 2011-26  | 6651(a)(1); No evidence of reasonable cause presented  | Yes    | IRS                    |
| <i>Hellweg v. Comm’r</i> , T.C. Memo. 2011-58  | 6651(a)(1); TPs not require to file disputed form so not liable for addition to tax                        | No     | TP                     |
| <i>Helms, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 6008 (S.D. Cal. 2010)   | 6651(a)(1); 6654; No evidence of reasonable cause or exception presented                                   | No     | IRS                    |

Table 4: Failure to File Penalty Under IRC § 6651(A)(1) and Failure to Pay Estimated Tax Penalty Under IRC § 6654

| Case Citation                                     | Issue(s)  | Pro Se | Decision                        |
|---|---|--------|---------------------------------|
| <i>Hultquist v. Comm’r</i> , T.C. Memo. 2011-17   | 6651(a)(1); No evidence of reasonable cause presented   | No     | IRS                             |
| <i>Jensen v. Comm’r</i> , T.C. Memo. 2010-143     | 6651(a)(1); 6654; Nonfiler; No evidence of reasonable cause or exception presented; IRS failed to meet burden of production for TY 2005 | Yes    | Split (TP 6654, IRS 6651(a)(1)) |
| <i>Lang v. Comm’r</i> , T.C. Memo. 2010-152       | 6651(a)(1); Reliance on tax preparer to file and obtain extension; No evidence of reasonable cause presented                            | Yes    | IRS                             |
| <i>Laszloffy v. Comm’r</i> , T.C. Memo. 2010-258  | 6651(a)(1); 6654; Nonfiler; No evidence of reasonable cause or exception presented  | Yes    | IRS                             |
| <i>Lewis v. Comm’r</i> , T.C. Summ. Op. 2010-156  | 6651(a)(1); 6654; No evidence of reasonable cause or exception presented  | Yes    | IRS                             |
| <i>Moore v. Comm’r</i> , T.C. Summ. Op. 2010-102  | 6651(a)(1); No evidence of reasonable cause presented   | Yes    | IRS                             |
| <i>Oglesby v. Comm’r</i> , T.C. Memo. 2011-93     | 6651(a)(1); No evidence of reasonable cause presented   | Yes    | IRS                             |
| <i>Olson v. Comm’r</i> , T.C. Summ. Op. 2010-96   | 6651(a)(1); No evidence of reasonable cause presented   | Yes    | IRS                             |
| <i>Pace v. Comm’r</i> , T.C. Memo. 2010-272       | 6651(a)(1); No evidence of reasonable cause presented   | Yes    | IRS                             |
| <i>Robinson v. Comm’r</i> , T.C. Memo. 2011-99    | 6651(a)(1); No evidence of reasonable cause presented   | Yes    | IRS                             |
| <i>Sanford v. Comm’r</i> , T.C. Summ. Op. 2011-4  | 6651(a)(1); No evidence of reasonable cause presented   | Yes    | IRS                             |
| <i>Steinshouer v. Comm’r</i> , T.C. Memo. 2011-53 | 6651(a)(1); 6654; Nonfiler; No evidence of reasonable cause presented   | Yes    | IRS                             |
| <i>Whipple v. Comm’r</i> , T.C. Memo. 2011-49     | 6651(a)(1); No evidence of reasonable cause presented   | Yes    | IRS                             |

**Table 5** Gross Income Under IRC § 61 and Related Sections

| Case Citation   | Issue(s)  | Pro Se | Decision |
|---|---|--------|----------|
| <b>Individual Taxpayers (But Not Sole Proprietorships)</b>  |   |        |          |
| <i>Abbott v. Comm’r</i> , T.C. Summ. Op. 2010-88  | Unreported state tax refund and cancellation of debt income   | Yes    | IRS      |
| <i>Alexander v. Comm’r</i> , T.C. Summ. Op. 2011-48   | Unreported payments received from state for providing care for TP’s elderly parents not excludable from gross income as foster care payments  | No     | IRS      |
| <i>Alonim v. Comm’r</i> , T.C. Memo. 2010-190   | Unreported interest income  | Yes    | IRS      |
| <i>Bayse v. Comm’r</i> , T.C. Summ. Op. 2010-118  | Unreported hazardous duty injury income not excludable from gross income as disability payments under a worker’s compensation act   | Yes    | IRS      |
| <i>Brown v. Comm’r</i> , T.C. Memo. 2011-83, <i>appeal docketed</i> , No. 11-2508 (7th Cir. June 30, 2011)    | Unreported taxable gain from termination of life insurance contract   | No     | IRS      |
| <i>Buckardt v. Comm’r</i> , T.C. Memo. 2010-145, <i>appeal docketed</i> (9th Cir. Sept. 15, 2010)             | Unreported pension and annuity distributions  | Yes    | IRS      |
| <i>Cadwell v. Comm’r</i> , 136 T.C. 38 (2011), <i>appeal docketed</i> , No. 11-1667 (4th Cir. June 23, 2011). | Conversion of a multi-employer plan to a single-employer plan, resulting in unreported life insurance premiums, cash value of life insurance policy, excess premiums, and mortality and other charges | No     | IRS      |
| <i>Callahan v. Comm’r</i> , T.C. Memo. 2010-201   | Unreported compensation for services  | Yes    | IRS      |
| <i>Chambers v. Comm’r</i> , T.C. Memo. 2011-114   | Parsonage allowance for unreported funds deposited into a church bank account over which TPs (H&W) had full control and used the funds to pay personal expenses                                       | No     | IRS      |
| <i>Chenault v. Comm’r</i> , T.C. Memo. 2011-56  | Unreported annuity contract income  | Yes    | Split    |
| <i>Chiarito v. Comm’r</i> , T.C. Summ. Op. 2010-149   | Unreported real estate gains  | Yes    | IRS      |
| <i>Crouse v. Comm’r</i> , T.C. Memo. 2011-97  | Unreported embezzled income   | Yes    | IRS      |
| <i>Driscoll v. Comm’r</i> , 135 T.C. 557 (2010), <i>appeal docketed</i> (11th Cir. May 24, 2011)              | Exclusion from gross income of parsonage allowance for second home  | No     | TP       |
| <i>Ernle v. Comm’r</i> , T.C. Memo. 2010-237  | Unreported retirement income, nonemployee compensation, and wage income   | Yes    | IRS      |
| <i>Espinoza v. Comm’r</i> , 636 F.3d 747 (5th Cir. 2011), <i>aff’g</i> T.C. Memo. 2010-53                     | Settlement proceeds under IRC § 104(a)(2).  | Yes    | IRS      |
| <i>Fennel v. Comm’r</i> , T.C. Summ. Op. 2011-19  | Unreported wage income  | Yes    | IRS      |
| <i>Gates v. Comm’r</i> , 135 T.C. 1 (2010), <i>appeal docketed</i> , No. 10-73209 (9th Cir. Oct. 19, 2010)    | Unreported capital gain income from the sale of real property excludable under IRC § 121  | No     | IRS      |
| <i>Gentile v. Comm’r</i> , T.C. Memo. 2010-254  | Unreported disability payment   | No     | IRS      |
| <i>Glover v. Comm’r</i> , T.C. Memo. 2010-228   | Unreported wage income  | Yes    | IRS      |
| <i>Greenberg v. Comm’r</i> , T.C. Memo. 2011-18   | Unreported punitive damage award from a lawsuit   | No     | IRS      |
| <i>Gregoline v. Comm’r</i> , T.C. Summ. Op. 2010-112  | Unreported wage income  | Yes    | IRS      |
| <i>Hale v. Comm’r</i> , T.C. Memo. 2010-229, <i>appeal docketed</i> , No. 10-73670 (9th Cir. Nov. 22, 2010)   | Unreported wage, interest, and rental income  | Yes    | IRS      |
| <i>Handy v. Comm’r</i> , T.C. Summ. Op. 2011-61   | Child support payments  | Yes    | IRS      |
| <i>Harper v. Comm’r</i> , T.C. Summ. Op. 2011-56  | Unreported payments received for providing care to TP’s disabled adult child  | Yes    | IRS      |
| <i>Hawkins v. Comm’r</i> , 386 Fed. Appx. 697 (9th Cir. 2010), <i>aff’g</i> T.C. Memo. 2007-286               | Settlement proceeds under IRC § 104(a)(2)   | Yes    | IRS      |
| <i>High v. Comm’r</i> , T.C. Summ. Op. 2011-36  | Settlement proceeds under IRC § 104(a)(2)   | Yes    | IRS      |
| <i>Hollingsworth v. Comm’r</i> , T.C. Memo. 2010-262  | Unreported retirement plan distributions  | Yes    | IRS      |
| <i>Holmes v. Comm’r</i> , T.C. Memo. 2011-26  | Unreported income earned in Iraq  | Yes    | IRS      |
| <i>Hyde v. Comm’r</i> , T.C. Memo. 2011-104   | Unreported compensation for services, dividend income, interest income, distribution from an IRA, and state tax refund  | Yes    | IRS      |

Table 5: Gross Income Under IRC § 61 and Related Sections

| Case Citation  | Issue(s)  | Pro Se | Decision |
|--|---|--------|----------|
| <i>Jeanmarie v. Comm’r</i> , T.C. Memo. 2010-281   | Unreported disability payments and interest income  | Yes    | IRS      |
| <i>Marchisio v. Comm’r</i> , T.C. Summ. Op. 2011-39  | Cancellation of debt income   | Yes    | TP       |
| <i>Martin v. Comm’r</i> , T.C. Summ. Op. 2011-62   | Unreported cancellation of debt income  | Yes    | IRS      |
| <i>Mathews v. Comm’r</i> , T.C. Memo. 2010-226   | Unreported retirement income  | Yes    | IRS      |
| <i>Mooney v. Comm’r</i> , T.C. Memo. 2011-35   | Unreported income   | Yes    | IRS      |
| <i>Nelson v. U.S.</i> , 392 Fed. Appx. 681 (11th Cir. 2010), <i>aff’g</i> 105 A.F.T.R.2d (RIA) 635 (N.D. Fla. 2010), <i>adopting</i> 105 A.F.T.R.2d (RIA) 627 (N.D. Fla. 2009) | Unreported wage income  | Yes    | IRS      |
| <i>Norwood v. Comm’r</i> , T.C. Summ. Op. 2011-27  | Unreported non-employee compensation  | Yes    | IRS      |
| <i>Oliver v. Comm’r</i> , T.C. Memo. 2011-44   | Settlement proceeds under IRC § 104(a)(2) and income from the sale of real property   | Yes    | IRS      |
| <i>Parkinson v. Comm’r</i> , T.C. Memo. 2010-142   | Settlement proceeds partially excludable under IRC § 104(a)(2) and unreported disability payments   | Yes    | Split    |
| <i>Rahall v. Comm’r</i> , T.C. Memo. 2011-101  | Unreported trust income, capital gains income, and bank deposits from unknown sources   | Yes    | IRS      |
| <i>Reynolds v. Comm’r</i> , T.C. Summ. Op. 2010-157  | Unreported rehabilitative alimony is not alimony for federal tax purposes   | No     | TP       |
| <i>Rocchio v. Comm’r</i> , T.C. Summ. Op. 2011-58  | Unreported undistributed S Corp income  | Yes    | IRS      |
| <i>Sanders v. Comm’r</i> , T.C. Memo. 2010-279   | Unreported constructive distribution from the termination of TP’s life insurance policy   | Yes    | IRS      |
| <i>Stipe v. Comm’r</i> , T.C. Memo. 2011-92  | Unreported disability payments  | Yes    | IRS      |
| <i>Tribin v. Comm’r</i> , T.C. Memo. 2010-224  | Unexplained bank deposits treated as unreported income but cash deposits to make loan payments on sister’s behalf not taxable   | Yes    | Split    |
| <i>Viralam v. Comm’r</i> , 136 T.C. No. 8 (2011)   | Unreported long term capital gains, dividends, and interest on investments in which the legal title was transferred to a charitable foundation  | No     | IRS      |
| <i>Williams v. Comm’r</i> , T.C. Summ. Op. 2010-86   | Unreported wages includable as gross income, but unemployment compensation includable in tax year not at issue in which compensation was paid, not in tax year at issue in which it was awarded | Yes    | Split    |
| <i>Zardo v. Comm’r</i> , T.C. Memo. 2011-7   | Unreported pension plan disability retirement benefits and unreported Social Security disability benefits   | Yes    | IRS      |
| <b>Business Taxpayers (Corporations, Partnerships, Trusts, and Sole Proprietorships – Schedules C, E, F)</b>   |   |        |          |
| <i>Brown v. Comm’r</i> , T.C. Summ. Op. 2010-97  | Unreported and unexplained deposits in a bank account with commingled business and personal funds   | Yes    | IRS      |
| <i>Cole v. Comm’r</i> , 637 F.3d 767 (7th Cir. 2011), <i>aff’g</i> T.C. Memo. 2010-31  | Unreported business income  | Yes    | IRS      |
| <i>Energy Research &amp; Generation, Inc. v. Comm’r</i> , T.C. Memo. 2011-45   | Unreported income   | No     | IRS      |
| <i>Fishman v. Comm’r</i> , T.C. Memo. 2011-102   | Unreported income from reimbursement of business expenses   | No     | TP       |
| <i>Garrison v. Comm’r</i> , T.C. Memo. 2010-261  | Unreported real estate transaction income   | Yes    | IRS      |
| <i>Hammond v. Comm’r</i> , T.C. Summ. Op. 2011-26  | Underreported gross receipts and unreported interest income   | Yes    | IRS      |
| <i>Holt v. Comm’r</i> , T.C. Summ. Op. 2010-92   | Underreported income  | Yes    | IRS      |
| <i>Jarman v. Comm’r</i> , T.C. Memo. 2010-285  | Unreported gross receipts, interest income, and state tax refund  | Yes    | IRS      |
| <i>Knutsen-Rowell, Inc. v. Comm’r</i> , T.C. Memo. 2011-65   | Unreported dividend income  | No     | IRS      |
| <i>MacGregor v. Comm’r</i> , T.C. Memo. 2010-187, <i>appeal docketed</i> , No. 11-70693 (9th Cir. Mar. 7, 2011)  | Settlement proceeds under IRC § 104(a)(2), unreported capital gains, and other unreported income  | Yes    | Split    |
| <i>O’Boyle v. Comm’r</i> , T.C. Memo. 2010-149, <i>appeal docketed</i> , No. 11-11897 (11th Cir. Apr. 25, 2011)  | Unreported capital gains income, income from the sale of real property, and compensation for services   | Yes    | IRS      |
| <i>Oglesby v. Comm’r</i> , T.C. Memo. 2011-93  | Unreported cancellation of debt income  | Yes    | IRS      |

Table 5: Gross Income Under IRC § 61 and Related Sections

| Case Citation   | Issue(s)   | Pro Se | Decision |
|---|--|--------|----------|
| <i>R.V.J. Cezar Corp., Inc. v. Comm’r</i> , T.C. Memo. 2010-173       | Unreported constructive dividends                    | No     | IRS      |
| <i>Tax Practice Management, Inc. v. Comm’r</i> , T.C. Memo. 2010-266  | Unreported constructive dividends                    | No     | IRS      |
| <i>Weekend Warrior Trailers, Inc. v. Comm’r</i> , T.C. Memo. 2011-105 | Unreported interest and constructive dividend income | No     | IRS      |

**Table 6 Accuracy-Related Penalty Under IRC § 6662(B)(1) and (2)**

| Case Citation  | Issue(s)  | Pro Se | Decision |
|--|---|--------|----------|
| <b>Individual Taxpayers (But Not Sole Proprietorships)</b>   |   |        |          |
| <i>Abiog v. Comm’r</i> , T.C. Summ. Op. 2010-166   | 6662(b)(1) & (2) - TP, a nonresident alien, acted in good faith and reasonably relied upon advice of a competent tax return preparer.   | No     | TP       |
| <i>Alexander v. Comm’r</i> , T.C. Summ. Op. 2011-48  | 6662(b)(1) - TP failed to properly substantiate disallowed items or to show reasonable cause and good faith.  | No     | IRS      |
| <i>Anyika v. Comm’r</i> , T.C. Memo. 2011-69   | 6662(b)(1) & (2) - TPs’ (H&W) reliance on tax return preparation software not reasonable.   | Yes    | IRS      |
| <i>Au v. Comm’r</i> , T.C. Memo. 2010-247  | 6662(b)(1) & (2) - TPs’ (H&W) reliance on tax return preparation software to claim fictitious deductions not reasonable.  | Yes    | IRS      |
| <i>Bosque v. Comm’r</i> , T.C. Memo. 2011-79   | 6662(b)(1) - TP not entitled to claimed deductions related to his rental properties   | Yes    | IRS      |
| <i>Brown v. Comm’r</i> , T.C. Memo. 2011-83, <i>appeal docketed</i> , No. 11-2508 (7th Cir. June 30, 2011) | 6662(b)(2) - TP husband substantially understated gross income by failing to claim recognized gain under termination of his life insurance. TPs failed to show neither reasonable cause nor good faith for the understatement.  | No     | IRS      |
| <i>Cadwell v. Comm’r</i> , 136 T.C. 38 (2011)  | 6662(b)(1) & (2) - TP substantially understated income by failing to report any wages, or the value of life insurance policy.   | No     | IRS      |
| <i>Calloway v. Comm’r</i> , 135 T.C. 26 (2010)   | 6662(b)(1) - TPs did not show their delay in filing was due to reasonable cause and not willful neglect, nor did they show reasonable reliance upon a competent professional adviser.   | No     | IRS      |
| <i>De Werff v. Comm’r</i> , T.C. Summ. Op. 2011-29   | 6662(b)(1) - TP failed to show that adviser was competent, that she provided adviser with necessary information, or that she relied in good faith on such advice to take the deductions at issue.   | Yes    | IRS      |
| <i>Dunn v. Comm’r</i> , T.C. Memo. 2010-198  | 6662(b)(1) - TP failed to show that he reasonably relied on tax advice regarding disallowed airplane rental and non-rental expenses.  | No     | IRS      |
| <i>Etchinson v. Comm’r</i> , T.C. Summ. Op. 2011-30  | 6662(b)(1) - TP failed to show reasonable cause or that she acted in good faith regarding disallowed deductions and filing status, nor did she make any attempt to recreate or substantiate her allegedly stolen records.   | Yes    | IRS      |
| <i>Gundanna v. Comm’r</i> , 136 T.C. No. 8 (2011)  | 6662(b)(1) & (2) - TP failed to substantiate a charitable contribution deduction.   | No     | IRS      |
| <i>Hammond v. Comm’r</i> , T.C. Summ. Op. 2011-26  | 6662(b)(1) - TP husband filed false and fraudulent return for 2004 and is thus liable for the fraud penalty under section 6663; alternative argument regarding section 6662(a) not addressed.   | Yes    | TP       |
| <i>Hamper v. Comm’r</i> , T.C. Summ. Op. 2011-17   | 6662(b)(1) - TP not entitled to deduct personal expenses.   | Yes    | IRS      |
| <i>Hartman v. Comm’r</i> , T.C. Summ. Op. 2010-164   | 6662(b)(1) - Though TP did not present adequate substantiating records to support business-related expenses at trial, 6662 penalty was rejected given TPs’ claim they had previously supplied documents to an IRS agent who IRS never called at trial.                        | Yes    | TP       |
| <i>Jarman v. Comm’r</i> , T.C. Memo. 2010-285  | 6662(b)(1) - TPs (H&W) failed to report income and maintain records to substantiate disallowed deductions.  | Yes    | IRS      |
| <i>Kaufman v. Comm’r</i> , 136 T.C. No. 13 (2011)  | 6662(b)(1) & (2) - TPs (H&W) were liable for penalty under 6662(b)(1) only as to claimed deductions for cash contributions, but acted in good faith with respect to their claimed contribution of a façade easement.  | No     | Split    |
| <i>Lumaban v. Comm’r</i> , T.C. Summ. Op. 2010-169   | 6662 - TP, a nonresident alien, reasonably relied upon advice of a competent tax return preparer and acted in good faith.   | No     | TP       |
| <i>Madsen v. Comm’r</i> , T.C. Summ. Op. 2010-151  | 6662(b)(1) - TP acted with reasonable cause and in good faith with respect to the portion of the underpayment attributable to her meal and expense rate travel expenses, but was negligent and had no reasonable cause to report disallowed deductions, labeled ‘incidental.’ | Yes    | Split    |
| <i>Malazarte v. Comm’r</i> , T.C. Summ. Op. 2010-168   | 6662(b)(1) - TP, a nonresident alien, reasonably relied upon advice of a competent tax return preparer and acted in good faith.   | No     | TP       |

Table 6: Accuracy-Related Penalty Under IRC § 6662(B)(1) and (2)

| Case Citation   | Issue(s)   | Pro Se | Decision |
|---|--|--------|----------|
| <i>Moss v. Comm’r</i> , 135 T.C. 365 (2010)   | 6662(b)(2) - TPs (H&W) failed to show they acted with reasonable cause and in good faith in deducting passive activity losses.   | Yes    | IRS      |
| <i>Norwood v. Comm’r</i> , T.C. Summ. Op. 2011-27   | 6662(b)(1) - TP failed to report nonemployee compensation as income.   | Yes    | IRS      |
| <i>Pagarigan v. Comm’r</i> , T.C. Summ. Op. 2010-167  | 6662(b)(1) - TP, a nonresident alien, reasonably relied upon advice of a competent tax return preparer and acted in good faith.  | No     | TP       |
| <i>Parker v. Comm’r</i> , T.C. Summ. Op. 2010-78  | 6662(b)(2) - TP failed to report any self-employment tax on 2005 and 2006 returns. TP’s reliance on tax return preparation software did not show reasonable cause or that he acted in good faith.  | Yes    | IRS      |
| <i>Parsley v. Comm’r</i> , T.C. Summ. Op. 2011-35   | 6662(b)(1) & (2) - TPs’ (H&W) experience and knowledge as real estate agents suggests that they knew or should have known the basis on which they computed their gain from the sale of property was inflated.  | Yes    | IRS      |
| <i>Rolfs v. Comm’r</i> , 135 T.C. 471 (2010)  | 6662(b)(1) & (2) - TPs’ (H&W) deduction for charitable contribution of a house to their local volunteer fire department was disallowed, but they were not liable for accuracy-related penalty as they acted with reasonable cause and in good faith based on a qualified appraisal of the value. | No     | TP       |
| <i>Savary v. Comm’r</i> , T.C. Summ. Op. 2010-150   | 6662(b)(1) - Comm’r failed to meet burden of production with regards to whether portions of income earned by U.S. citizen residing in France were underreported.   | No     | TP       |
| <i>Scroggins v. Comm’r</i> , T.C. Memo. 2011-103  | 6662(b)(1) - TPs (H&W) not entitled to claimed travel deductions.  | No     | IRS      |
| <i>Stenslet v. Comm’r</i> , T.C. Summ. Op. 2010-127   | 6662(b)(1) - TPs (H&W) reasonably relied upon a tax preparer to prepare their returns.   | Yes    | TP       |
| <i>Stewart v. Comm’r</i> , T.C. Memo. 2010-184  | 6662(b)(1) - TP acted in good faith or with reasonable cause in regards to bad debt and legal expense deductions, but did not have a good faith or reasonable cause defense with regards to unsubstantiated theft losses, travel, and automobile expenses.                                       | Yes    | Split    |
| <i>Stroff v. Comm’r</i> , T.C. Memo. 2011-80  | 6662(b)(1) - TP entitled to deductions for casual labor expenses and accuracy-related penalty was unwarranted, but penalty was warranted with respect to other disallowed deductions.  | Yes    | Split    |
| <i>Ucol-Cobaria v. Comm’r</i> , T.C. Summ. Op. 2010-162   | 6662(b)(1) - TP, a nonresident alien, reasonably relied upon advice of a competent tax return preparer and acted in good faith.  | No     | TP       |
| <i>Viralam v. Comm’r</i> , 136 T.C. No. 8 (2011)  | 6662(b)(1) - TP failed to substantiate a charitable contribution deduction and failed to include long-term capital gain from the sale of stocks in gross income.   | No     | IRS      |
| <i>Wadsworth v. Comm’r</i> , 400 Fed. Appx. 289 (9th Cir. 2011), <i>aff’g</i> T.C. Memo. 2008-171                 | 6662(b)(1) - TPs ignored advice of longtime tax preparer and introduced no evidence at trial to explain why they disregarded the advice.   | No     | IRS      |
| <i>Whitaker v. Comm’r</i> , T.C. Memo. 2010-209   | 6662(b)(2) - TP failed to substantiate her Sch. C gross receipts, Sch. C deductions, long-term capital gain, & Sch. E rental expenses; pending final calculation of understatement, TP liable for penalty.   | No     | IRS      |
| <i>Winter v. Comm’r</i> , T.C. Memo. 2010-287   | 6662(b)(1) - Comm’r failed to meet burden of production.   | No     | TP       |
| <i>Zhu v. Comm’r</i> , T.C. Summ. Op. 2010-67   | 6662(b)(1) - TP was allowed to deduct some gambling losses, but was negligent in overstating gambling losses and not reporting capital gain.   | Yes    | IRS      |
| <b>Business Taxpayers (Corporations, Partnerships, Trusts, and Sole Proprietorships – Schedules C, E, F)</b>      |  |        |          |
| <i>106 Ltd. v. Comm’r</i> , 136 T.C. 67 (2011), <i>appeal docketed</i> , No. 11-60342 (5th Cir. May 20, 2011)     | 6662(b)(1) - TP failed to show good faith or reasonable cause for entering into a Son-of-BOSS transaction.   | No     | IRS      |
| <i>Adams v. Comm’r</i> , T.C. Summ. Op. 2010-134  | 6662(b)(1) - TPs (H&W) claimed personal expenses as business expenses and failed to maintain records to substantiate deductions.   | Yes    | IRS      |
| <i>Bemont Invs., LLC v. U.S.</i> , 106 A.F.T.R.2d (RIA) 5542 (E.D. Tex. 2010)                                     | 6662(b)(1) - Negligence penalties were applicable with regards to transactions that had no economic benefit and lacked economic substance; TP Partnership did not show reasonable cause or good faith, but statute of limitations had run on 2001 tax year.                                      | No     | Split    |
| <i>Canal Corp. v. Comm’r</i> , 135 T.C. 199 (2010), <i>appeal docketed</i> , No. 10-2253 (4th Cir. Oct. 29, 2010) | 6662(b)(1) - TP failed to report gain and unreasonably relied on opinion of tax advisor with a conflict of interest.   | No     | IRS      |
| <i>Fid. Int’l Currency Advisor A Fund, LLC v. U.S.</i> , 747 F. Supp. 2d 49 (D. Mass. 2010)                       | 6222(b)(1) & (2) - TPs entered into complex tax shelter transactions to avoid large tax liabilities on the sale of stock.  | No     | IRS      |

Table 6: Accuracy-Related Penalty Under IRC § 6662(B)(1) and (2)

| Case Citation   | Issue(s)   | Pro Se | Decision |
|---|--|--------|----------|
| <i>Hafeez v. Comm'r</i> , T.C. Summ. Op. 2010-109   | 6662(b)(1) - TP was entitled to some of the disallowed items, but failed to show reasonable cause or that he acted in good faith on advice from his preparer.        | Yes    | IRS      |
| <i>Historic Boardwalk Hall, LLC v. Comm'r</i> , 136 T.C. 1 (2011), appeal docketed, (3rd Cir. Mar. 29, 2011)                      | 6662(b)(1) - Respondent's determinations in FPAA were incorrect, accuracy-related penalties were thus inapplicable.  | No     | TP       |
| <i>Karkour v. Comm'r</i> , T.C. Memo. 2010-124  | 6662(b)(1) & (2) - TP failed to substantiate deductions or provide evidence at trial to prove reasonable cause or good faith.  | Yes    | IRS      |
| <i>Klebanoff v. Comm'r</i> , T.C. Summ. Op. 2011-46   | 6662 (b)(1) & (2) - TP satisfied the reasonable cause exception, TP consulted with tax professionals who advised her to file an amended partnership return.          | No     | TP       |
| <i>Moore v. Comm'r</i> , T.C. Summ. Op. 2011-51   | 6662(b)(1) & (2) - TP failed to substantiate personal and duplicate deductions on his Sch. C-1 & C-2; reliance on computer program was not reasonable cause.         | Yes    | IRS      |
| <i>Mulcahy, Pauritsch, Salvador &amp; Co. v. Comm'r</i> , T.C. Memo. 2011-74, appeal docketed, No. 11-2105 (7th Cir. May 9, 2011) | 6662(b)(2) - TP not entitled to claimed deductions.  | No     | IRS      |
| <i>NPR Invs., LLC v. U.S.</i> , 732 F. Supp. 2d 676 (E.D. Tex. 2010)  | 6662(b)(1) & (2) - TPs acted reasonably in relying on tax advisor.   | No     | TP       |
| <i>Sada v. Comm'r</i> , T.C. Summ. Op. 2010-146   | 6662(b)(1) - TPs (H&W) failed to maintain and produce adequate records to substantiate deductions and failed to show they acted with reasonable cause or good faith. | Yes    | IRS      |
| <i>Sakkis v. Comm'r</i> , T.C. Memo. 2010-256   | 6662(b)(1) - TPs (H&W) disregarded advice of long-time competent tax preparer and relied on advice of a shyster, eliminating good faith reliance defense.            | No     | IRS      |
| <i>Shokeh v. Comm'r</i> , T.C. Summ. Op. 2010-71  | 6662(b)(1) - TP claimed inflated Sch. C expenses for a fictitious consulting business and failed to show reasonable cause or good faith.                             | Yes    | IRS      |
| <i>Stobie Creek Invs. LLC v. U.S.</i> , 608 F.3d 1366 (Fed. Cir. 2010), <i>aff'g</i> 82 Fed. Cl. 636 (Fed. Cl. 2008)              | 6662(b)(1) - TPs did not act with reasonable cause or in good faith regarding underpayments resulting from sham transactions to conceal gain.                        | No     | IRS      |
| <i>Tax Practice Mgmt. v. Comm'r</i> , T.C. Memo. 2010-266   | 6662(b)(1) - TP failed to show reasonable cause, substantial authority, or any other basis for reducing the penalties for underpayment.                              | No     | IRS      |
| <i>Weekend Warrior Trailers, Inc. v. Comm'r</i> , T.C. Memo. 2011-105   | 6662(b)(2) - TP not entitled to claimed business deductions.   | No     | IRS      |

**Table 7**      **Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax Under IRC § 7403**

| Case Citation  | Issue(s)  | Pro Se | Decision |
|--|---|--------|----------|
| <b>Individual Taxpayers (But Not Sole Proprietorships)</b>   |   |        |          |
| <i>Ameritrust Mortgage Co. v. Savalle</i> , 107 A.F.T.R.2d (RIA) 416 (E.D. Mich. 2011)   | Federal tax liens foreclosed against TP's jointly owned real property.  | No     | IRS      |
| <i>Anderson, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 7356 (W.D.N.Y. 2010)   | Foreclosure of federal tax liens against the TP's interest in jointly owned real property denied; material factual dispute existed whether the government would be prejudiced and whether the joint tenant (wife) would be harmed.  | No     | TP       |
| <i>Barr, U.S. v.</i> , 617 F.3d 370 (6th Cir. 2010), <i>aff'g</i> 102 A.F.T.R.2d (RIA) 6078 (E.D. Mich. 2008), <i>reh'g en banc denied</i> , 106 A.F.T.R.2d (RIA) 6893 (6th Cir. 2010), <i>cert. denied</i> , 131 S. Ct. 1678 (2011) | Federal tax liens foreclosed against TP's jointly owned real property.  | No     | IRS      |
| <i>Benice, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 6485 (C.D. Cal. 2010)  | Federal tax liens valid and foreclosed against TP's real property and property held by TP's nominee.  | Yes    | IRS      |
| <i>Benoit, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 1056 (S.D. Cal. 2010), <i>reconsideration denied</i> by 107 A.F.T.R.2d (RIA) 2577 (S.D. Cal. 2011), <i>appeal dismissed</i> (9th Cir. Oct. 19, 2011)                                   | Federal tax liens valid and foreclosed against TP's real property.  | Yes    | IRS      |
| <i>Black, U.S. v.</i> , 725 F. Supp. 2d 1279 (E.D. Wash. 2010), <i>motion to dismiss denied</i> by 106 A.F.T.R.2d (RIA) 5320 (E.D. Wash. 2010), <i>appeal docketed</i> (9th Cir. Oct. 6, 2011)                                       | Federal tax liens valid and foreclosed against TP's (H&W) property and property held by TP's nominees.  | Yes    | IRS      |
| <i>Bowser, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 1240 (E.D. Va. 2011)   | Federal tax lien foreclosed against TP's property held as joint tenants in the entirety with wife.  | No     | IRS      |
| <i>Brown, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 392 (E.D. Tex. 2010), <i>adopted by</i> 107 A.F.T.R.2d (RIA) 398 (E.D. Tex. 2011)   | Federal tax lien foreclosed against TP's (H&W) real property.   | Yes    | IRS      |
| <i>Buaiz, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 6168 (E.D. Tenn. 2010), <i>motion to dismiss denied</i> by 108 A.F.T.R.2d (RIA) 5856 (E.D. Tenn. 2011)  | Federal tax lien valid against TP's property and property held by TP's nominee; foreclosure denied pending further briefing.  | Yes    | Split    |
| <i>Burnett, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 6699 (S.D. Tex. 2010), <i>appeal docketed</i> (5th Cir. Dec. 22, 2010)  | Federal tax lien foreclosed against TP's property held by nominee.  | No     | IRS      |
| <i>Campbell, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 6488 (C.D. Cal. 2010)  | Federal tax liens valid and foreclosed against 100% of real property owned by TP's (H&W), despite H's transfer of 80% of the property to his four siblings at a time when the IRS had not refiled its Notice of Federal Tax Lien because there was no consideration for the transfer. | Yes    | IRS      |
| <i>Case, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 6421 (N.D.N.Y. 2010), <i>adopted by</i> 106 A.F.T.R.2d (RIA) 6473 (N.D.N.Y. 2010), <i>appeal docketed</i> (2nd Cir. Oct. 25, 2011)   | Default judgment against TP; federal tax liens valid and foreclosed against TP's property.  | Yes    | IRS      |
| <i>Christiansen, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 840 (11th Cir. 2011) ( <i>per curiam</i> ), <i>aff'g</i> 107 A.F.T.R.2d (RIA) 937 (M.D. Fla. 2010)   | Foreclosure of federal tax liens against TP's real property affirmed.   | Yes    | IRS      |
| <i>D'Andrea, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 6456 (D. Colo. 2010), <i>adopting</i> 106 A.F.T.R.2d (RIA) 6446 (D. Colo. 2010)  | Federal tax lien valid and foreclosed against property transferred by TP (deceased) to plaintiff.   | Yes    | IRS      |
| <i>DuBarry, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 1632 (N.D. Fla. 2011), <i>adopting</i> 107 A.F.T.R.2d (RIA) 1625 (N.D. Fla. 2011) <i>appeal dismissed</i> (11th Cir. Sept. 22, 2011)  | Federal tax liens foreclosed against TP's real property.  | Yes    | IRS      |
| <i>Elsberg, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 7240 (D. Colo. 2010), <i>adopting</i> 106 A.F.T.R.2d (RIA) 7236 (D. Colo. 2010)   | Default judgment against TP's (H&W); federal tax liens valid and foreclosed against TP's real property.   | Yes    | IRS      |
| <i>Felt, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 2239 (D. Utah 2011)  | Federal tax liens valid and foreclosed against TP's real property held by nominee.  | Yes    | IRS      |

Table 7: Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax Under IRC § 7403

| Case Citation   | Issue(s)   | Pro Se | Decision |
|---|--|--------|----------|
| <i>Flaherty, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 6873 (D. Haw. 2010), judgment entered by 2010 U.S. Dist. LEXIS 125158 (D. Haw. 2010)  | Federal tax liens valid and foreclosed against TP's real property.   | Yes    | IRS      |
| <i>Gallina, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 1326 (E.D.N.Y. 2011), adopting 107 A.F.T.R.2d (RIA) 1469 (E.D.N.Y. 2010)   | Federal tax liens valid and foreclosed against TP's (H&W) real property.   | Yes    | IRS      |
| <i>Gavett, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 2171 (D.N.J. 2011)  | Federal tax liens foreclosed against TP's (H&W) real property despite transfer of deed to his children after the filing of the lien.   | Yes    | IRS      |
| <i>J. P. Morgan Chase Bank, N.A., U.S. v.</i> , 107 A.F.T.R.2d (RIA) 1516 (E.D.N.Y. 2011), adopting 107 A.F.T.R.2d (RIA) 1841 (E.D.N.Y. 2010)   | Federal tax lien valid and foreclosed against decedent TP's real property.   | No     | IRS      |
| <i>Johnson, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 2330 (E.D. Mo. 2011)   | Federal tax liens valid and foreclosed against TP's (H&W) real property.   | No     | IRS      |
| <i>Jones, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 499 (N.D. Cal. 2011)   | Federal tax lien foreclosed against the TP's one-half interest in real property transferred to ex-wife in divorce for taxes accrued prior to transfer.   | No     | IRS      |
| <i>Lockard, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 6971 (E.D. Mich. 2010)   | Federal tax lien foreclosed against TP's (H&W) real property.  | No     | IRS      |
| <i>Lupi, U.S. v.</i> , 105 A.F.T.R.2d (RIA) 2806 (M.D. Fla. 2010)   | Federal tax liens valid and foreclosed against TP's property held in trust by TP's nominee.  | Yes    | IRS      |
| <i>McKenzie, U.S. v.</i> , 108 A.F.T.R.2d (RIA) 5516 (S.D. Iowa 2011), appeal docketed (8th Cir. Sept. 23, 2011)  | Federal tax liens foreclosed against property held by TP's nominees; TP's transfers of property to trust and family members were fraudulent.   | No     | IRS      |
| <i>Morgan, U.S. v.</i> , 419 Fed. Appx. 958 (11th Cir. 2011) (per curiam), aff'g 105 A.F.T.R.2d (RIA) 442 (M.D. Fla. 2010)  | Affirmed lower court's decision to foreclose federal tax liens against TP's (H&W) real property held by nominee.   | Yes    | IRS      |
| <i>Niamatali, U.S. v.</i> , 389 Fed. Appx. 334 (5th Cir. 2010) (per curiam), aff'g 07-00108 (S.D. Tex. 2009)  | Affirmed lower court's decision to foreclose federal tax liens against TP's real property.   | Yes    | IRS      |
| <i>OMOA Wireless, S. de R. L. v. U.S.</i> , 106 A.F.T.R.2d (RIA) 5810 (M.D.N.C. 2010)   | Federal tax liens foreclosed against property held by TP's nominees.   | No     | IRS      |
| <i>Palmer, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 6297 (D. Utah 2010)   | Federal tax liens valid and foreclosed against TP's real property.   | No     | IRS      |
| <i>Porath, U.S. v.</i> , 764 F. Supp. 2d 883 (E.D. Mich. 2011), appeal docketed (6th Cir. Apr. 1, 2011), appeal dismissed (6th Cir. April 22, 2011), appeal reinstated (6th Cir. May 3, 2011)             | Federal tax lien on TP's one-half interest in home valid and foreclosure of liens delayed so long as TP and W live in home.  | No     | IRS      |
| <i>Register, U.S. v.</i> , 717 F. Supp. 2d 517 (E.D. Va. 2010)  | Federal tax liens foreclosed against TP's jointly owned real property.   | No     | IRS      |
| <i>Sebastian, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 5160 (M.D. Pa. 2010)   | Federal tax liens valid and foreclosed against TP's (H&W) real property.   | Yes    | IRS      |
| <i>Stuler, U.S. v.</i> , 396 Fed. Appx. 798 (3d Cir. 2010) (per curiam), dismissing appeal from 105 A.F.T.R.2d (RIA) 764 (W.D. Pa. 2010)  | Dismissed appeal of federal tax lien foreclosure for lack of arguable basis in law or fact.  | Yes    | IRS      |
| <i>Wheeler, U.S. v.</i> , 403 Fed. Appx. 301 (9th Cir. 2010) aff'g 07-06384 (C.D. Ca. 2008)   | Affirmed lower court's decision to foreclose federal tax liens against property held by TP's nominee.  | No     | IRS      |
| <i>Winsper, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 6437 (W.D. Ky. 2010), appeal docketed (6th Cir. Dec. 27, 2010)   | Federal tax liens on TP's real property valid, but foreclosure denied for lack of information regarding property's value, method of distribution of proceeds of foreclosure sale, amount due to other creditors. | No     | Split    |
| <i>Winsper, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 6945 (W.D. Ky. 2010)   | Foreclosure of federal tax liens on marital property not appropriate; wife of TP would be unduly harmed by forced sale of property.  | No     | TP       |
| <i>Zimmerman, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 1887 (E.D. Pa. 2011), order entered by 2011 WL 1483349 (E.D. Pa. 2011), motion for relief from judgment and to vacate sale filed (E.D. Pa. Nov. 3, 2011) | Federal tax liens valid and foreclosed against TP's (H&W) real property and property held in trust by TP's nominee.  | Yes    | IRS      |

Table 7: Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax Under IRC § 7403

| Case Citation  | Issue(s)  | Pro Se | Decision |
|--|---|--------|----------|
| <b>Business Taxpayers (Corporations, Partnerships, Trusts, and Sole Proprietorships - Schedules C, E, F)</b>                                 |   |        |          |
| <i>Eckhardt v. U.S.</i> , 2010 U.S. Dist. LEXIS 142176 (S.D. Fla. 2010)  | Federal tax lien valid and foreclosed against corporation and H's portion of marital property, as the corporation's alter ego; federal tax lien against W's portion of marital property is invalid. | No     | Split    |
| <i>Electro-Cut Forging Die Co., U.S. v.</i> , 106 A.F.T.R.2d (RIA) 5602 (N.D. Ohio 2010), <i>adopted by</i> 106 A.F.T.R.2d (RIA) 5606 (2010) | Federal tax liens valid and foreclosed against TP's real property.  | No     | IRS      |
| <i>Lee, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 1774 (N.D. Cal. 2011)   | Federal tax liens foreclosed against TP's real property.  | No     | IRS      |
| <i>Martin, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 1795 (N.D. W. Va. 2011)  | Federal tax liens valid but not foreclosed against TP's real property because issue of material fact remained as to whether the federal liens holds superiority over other interests.               | Yes    | IRS      |
| <i>Neal, U.S. v.</i> , 391 Fed. Appx. 569 (8th Cir. 2010) (per curiam), <i>aff'g</i> 103 A.F.T.R.2d (RIA) 643 (W.D. Ark. 2008)               | Affirmed lower court's decision to foreclose federal tax liens against TP's real and personal property held by nominee.   | Yes    | IRS      |
| <i>Philadelphia Housing Authority v. STA Painting Co., Inc.</i> , 106 A.F.T.R.2d (RIA) 7406 (E.D. Pa. 2010)                                  | Valid federal tax lien foreclosed against funds due to TP from PHA; TP may not direct allocation of funds   | No     | IRS      |
| <i>Steeley, U.S.</i> , 106 A.F.T.R.2d (RIA) 5581 (N.D. Fla. 2010)  | Federal tax liens valid and foreclosed against TP's property.   | No     | IRS      |
| <i>Vacante, U.S. v.</i> , 106 A.F.T.R.2d (RIA) 6415 (N.D. Cal. 2010)   | Federal tax liens valid and foreclosed against TP's (H&W) real property.  | Yes    | TP       |
| <i>Wesselman, U.S. v.</i> , 406 Fed. Appx. 64 (7th Cir. 2011), <i>aff'g</i> 105 A.F.T.R.2d (RIA) 2021 (S.D. Ill. 2010)                       | Affirmed lower court's decision to foreclose federal tax liens against TP's real property held by nominee.  | Yes    | IRS      |
| <i>Zurn, U.S. v.</i> , 107 A.F.T.R. 2d (RIA) 2127 (9th Cir. 2011), <i>aff'g</i> 103 A.F.T.R.2d (RIA) 939 (C.D. Cal. 2009)                    | Affirmed lower court's decision to foreclose federal tax liens against TP's property.   | No     | IRS      |

**Table 8** Relief from Joint and Several Liability Under IRC § 6015

| Case Citation  | Issue(s)  | Pro Se | Intervenor | Decision |
|--|---|--------|------------|----------|
| <i>Argyle v. Comm'r</i> , T.C. Summ. Op. 2010-129  | 6015(f) (underpayment); claim made after the two year rule of Treas. Reg. 1.6015-5(b)(1)  | Yes    | No         | IRS      |
| <i>Bland v. Comm'r</i> , T.C. Memo 2011-8  | 6015(f) (underpayment); claim made after the two year rule of Treas. Reg. 1.6015-5(b)(1)  | Yes    | No         | IRS      |
| <i>Brady v. Comm'r</i> , T.C. Summ. Op. 2010-107   | No joint return   | Yes    | No         | IRS      |
| <i>Cody v. Comm'r</i> , T.C. Summ. Op. 2011-49   | 6015(f) (underpayment)  | No     | Yes        | TP       |
| <i>Collis v. Comm'r</i> , T.C. Summ. Op. 2010-91   | 6015(b), (c), (f) (understatement)  | Yes    | No         | Split    |
| <i>Conyers v. Comm'r</i> , T.C. Summ. Op. 2011-25  | 6015(b), (c), (f) (understatement)  | Yes    | No         | IRS      |
| <i>Crouse v. Comm'r</i> , T.C. Memo. 2011-97   | 6015(b), (c), (f) (understatement)  | Yes    | No         | Split    |
| <i>Daye v. Comm'r</i> , T.C. Summ. Op. 2010-103  | 6015(f) (underpayment)  | Yes    | Yes        | IRS      |
| <i>Downs v. Comm'r</i> , T.C. Memo. 2010-165   | 6015(f) (underpayment)  | No     | Yes        | TP*      |
| <i>Drayer v. Comm'r</i> , T.C. Memo. 2010-257  | 6015(f) (underpayment)  | No     | No         | TP       |
| <i>Dulaney v. Comm'r</i> , T.C. Summ. Op. 2011-38  | 6015(b), (c) (understatement)   | Yes    | Yes        | TP       |
| <i>Dykes v. Comm'r</i> , T.C. Summ. Op. 2010-85  | 6015(b), (c), (f) (understatement)  | Yes    | No         | IRS      |
| <i>Evans v. Comm'r</i> , T.C. Memo. 2010-199, <i>appeal docketed</i> , No.10-73745 (9th Cir. Dec. 8, 2010)                     | 6015(b),(c), (f) (understatement)   | No     | No         | IRS      |
| <i>Gilbert v. Comm'r</i> , 107 A.F.T.R. 2d (RIA) 2062 (9th Cir. 2011), <i>affirming</i> T.C. Docket No. 9996-04 (July 7, 2005) | 6015(f) (underpayment)  | Yes    | No         | IRS      |
| <i>Haag v. Comm'r</i> , T.C. Memo. 2011-87, <i>appeal docketed</i> , No. 11-1979 (1st Cir. Aug. 19, 2011)                      | 6015(g) prior proceedings bar relief  | No     | No         | IRS      |
| <i>Hall v. Comm'r</i> , 135 T.C. 374, <i>appeal docketed</i> , No. 10-2628 (6th Cir. Dec. 14, 2010)                            | 6015(f) (underpayment); IRS conceded that relief would be appropriate but for the two year rule of Treas. Reg. 1.6015-5(b)(1)   | No     | No         | TP       |
| <i>Harper v. Comm'r</i> , T.C. Summ. Op. 2010-153  | 6015(f) (underpayment); claim made after the two year rule of Treas. Reg. 1.6015-5(b)(1)  | Yes    | No         | TP       |
| <i>Hayes v. Comm'r</i> , T.C. Summ. Op. 2010-121   | 6015(b), (c), (f) (understatement)  | Yes    | Yes        | Split    |
| <i>Jones v. Comm'r</i> , 642 F.3d 439 (4th Cir. 2011) <i>rev'g and remanding</i> T.C. Docket No. 17359-08 (May 28, 2010)       | 6015(f) (underpayment); Treas. Reg. 1.6015-5(b)(1) application of a two-year rule to claims for relief under section 6015(f) is a valid interpretation of section 6015(f).  | No     | No         | IRS      |
| <i>Kelly v. Comm'r</i> , T.C. Memo. 2010-267   | 6015(f) (underpayment); claim made after the two year rule of Treas. Reg. 1.6015-5(b)(1)  | No     | No         | IRS      |
| <i>Knight v. Comm'r</i> , T.C. Memo. 2010-242  | 6015(c) (understatement)  | Yes    | Yes        | TP*      |
| <i>Kruse v. Comm'r</i> , T.C. Memo. 2010-270   | 6015(b), (c), (f) (understatement)  | Yes    | No         | IRS      |
| <i>Lantz v. Comm'r</i> , 607 F.3d 479 (7th Cir. 2010), <i>rev'g and remanding</i> 132 T. C. 131 (2009)                         | 6015 (f) (underpayment); Treas. Reg. 1.6015-5(b)(1) application of a two-year rule to claims for relief under section 6015(f) is a valid interpretation of section 6015(f). | No     | No         | IRS+     |
| <i>Mannella v. Comm'r</i> , 631 F.3d 115 (3d Cir. 2011), <i>rev'g and remanding</i> 132 T.C. 196 (2009)                        | 6015(f) (underpayment); Treas. Reg. 1.6015-5(b)(1) application of a two-year rule to claims for relief under section 6015(f) is a valid interpretation of section 6015(f).  | No     | No         | IRS      |
| <i>Maudi v. Comm'r</i> , T.C. Summ. Op. 2011-57  | 6015(f) (understatement); claim made after the two year rule of Treas. Reg. 1.6015-5(b)(1)  | No     | No         | TP       |
| <i>McGhee v. Comm'r</i> , T.C. Memo. 2010-259  | 6015(f) (underpayment)  | No     | No         | IRS      |
| <i>Milhouse v. Comm'r</i> , T.C. Summ. Op. 2011-12   | 6015(c) (understatement)  | Yes    | Yes        | TP       |

\*The IRS agreed that the TP was entitled to relief; only the intervenor was opposed.

+ The case was also included in last year's report.

Table 8: Relief from Joint and Several Liability Under IRC § 6015

| Case Citation   | Issue(s)   | Pro Se | Intervenor | Decision |
|---|--|--------|------------|----------|
| <i>Mullins v. Comm’r</i> , T.C. Summ. Op. 2010-108  | 6015(b), (c), (f) (understatement)   | Yes    | Yes        | IRS      |
| <i>Nicoletti v. Comm’r</i> , T.C. Summ. Op. 2010-93   | 6015(f) (underpayment)   | Yes    | No         | IRS      |
| <i>Olivera v. Comm’r</i> , T.C. Summ. Op. 2010-119  | 6015 (b), (c), (f) (understatement, underpayment)  | Yes    | No         | Split    |
| <i>Pinsky, U.S. v.</i> , 107 A.F.T.R.2d (RIA) 1597 (D.N.J. Mar. 31, 2011)   | District Court willing to consider 6015 claim in collection suit, but raised too late in proceedings | No     | No         | IRS      |
| <i>Pugsley v. Comm’r</i> , T.C. Memo. 2010-255  | 6015 (f) (underpayment)  | No     | No         | IRS      |
| <i>Pullins v. Comm’r</i> , 136 T.C. No. 20 (2011)   | 6015(f) (underpayment); claim made after the two year rule of Treas. Reg. 1.6015-5(b)(1)             | No     | No         | TP       |
| <i>Riganti v. Comm’r</i> , T.C. Summ. Op. 2010-113  | 6015(f) (underpayment)   | Yes    | No         | IRS      |
| <i>Schultz v. Comm’r</i> , T.C. Memo. 2010-233  | 6015(f) (understatement)   | No     | No         | Split    |
| <i>Simcox v. Comm’r</i> , T.C. Summ. Op. 2010-101   | 6015(f) (underpayment); petition not timely  | No     | No         | IRS      |
| <i>Smith v. Comm’r</i> , T.C. Memo. 2010-240, <i>appeal docketed</i> , No.11-9003 (10th Cir. Feb. 8, 2011)                    | 6015(b), (c), (f) (understatement)   | Yes    | No         | IRS      |
| <i>Smolen v. Comm’r</i> , T.C. Summ. Op. 2010-106   | 6015(f) (underpayment)   | No     | No         | IRS      |
| <i>Sommer, Estate of v. Comm’r</i> , T.C. Summ. Op. 2010-177  | 6015(f) (underpayment)   | No     | No         | IRS      |
| <i>Stephenson v. Comm’r</i> , T.C. Memo. 2011-16  | 6015(f) (underpayment); claim made after the two year rule of Treas. Reg. 1.6015-5(b)(1)             | Yes    | No         | TP       |
| <i>Taylor v. Comm’r</i> , 107 A.F.T.R. 2d (RIA) 1361 (9th Cir. 2011), <i>affirming</i> T.C. Memo. 2008-193                    | 6015(b), (c), (f) (understatement)   | Yes    | No         | IRS      |
| <i>Terrell v. Comm’r</i> , 625 F.3d 254 (5th Cir. 2011), <i>rev’g and remanding</i> T. C. Docket No. 15894-07 (July 30, 2009) | Undelivered notice of determination did not begin 90-day period for petitioning Tax Court.           | No     | No         | TP       |
| <i>Thomassen v. Comm’r</i> , T.C. Memo. 2011-88   | 6015(b), (c), (f) (understatement)   | No     | No         | Split    |
| <i>Wilson v. Comm’r</i> , T.C. Memo. 2010-134, <i>appeal docketed</i> No.10-72754 (9th Cir. Sept. 10, 2010)                   | 6015(f) (underpayment)   | No     | No         | TP       |
| <i>Withers v. Comm’r</i> , T.C. Summ. Op. 2010-73   | 6015(f) (underpayment)   | Yes    | No         | TP       |

\*The IRS agreed that the TP was entitled to relief, only the intervenor was opposed.

+ The case was also included in last year's report.

**Table 9** Frivolous Issues Penalty Under IRC § 6673 and Related Appellate-Level Sanctions

| Case Citation  | Issue(s)  | Pro Se | Decision |          |
|--|---|--------|----------|----------|
| <b>Individual Taxpayers (But not Sole Proprietorships)</b> |   |        |          |          |
| <i>Anyika v. Comm’r</i> , T.C. Memo. 2011-69               | Taxpayers (H&W) petitioned for redetermination of deficiency and penalties and argued taxpayer (H) was a real estate professional   | Yes    | TP       |          |
| <i>Buckardt v. Comm’r</i> , T.C. Memo. 2010-145            | Taxpayer petitioned for redetermination of deficiency and argued his pension and annuity income are excluded from taxation, and that an assessment must precede a notice of deficiency  | Yes    | TP       |          |
| <i>Burchfield v. Comm’r</i> , T.C. Memo. 2011-30           | Taxpayers (H&W) petitioned for redetermination of deficiency and additions to tax and argued that only income earned from the federally licensed corporations and dividends are taxable; the word income does not include the earnings of employees of the private sector; they are residents of the “several States”; income tax can only be collected through the states; the court may only set the rate of tax; the IRS cannot issue a deficiency notice without making an assessment; and their Form 1040 must be accepted because it is not frivolous on its face | Yes    | IRS      | \$5,000  |
| <i>Callahan v. Comm’r</i> , T.C. Memo. 2010-201            | Taxpayer petitioned for redetermination of deficiency and additions to tax and argued that he is a citizen of the “Republic of Wisconsin,” not the State of Wisconsin or the United States, and therefore not liable for federal taxes; the Form 1099-MISC reflecting his compensation is not signed under penalties of perjury; and that the Tax Court may not use other Tax Court cases as precedent  | Yes    | IRS      | \$3,000  |
| <i>Cook v. Comm’r</i> , T.C. Memo. 2010-137                | Taxpayer petitioned for redetermination of deficiency and additions to tax and made arguments common to followers of the Robert Clarkson- Patriot Network, which promotes tax avoidance; that the IRS relied on hearsay; that third party reports of his income are not authenticated or certified; that he believed that he had no tax liabilities; that he received no Forms W-2; and that he had no recollection of his earnings or IRA distribution   | Yes    | TP       |          |
| <i>Covington v. Comm’r</i> , T.C. Memo. 2011-32            | Taxpayer petitioned for review of IRS decision to collect via levy and asserted frivolous arguments that the abbreviation of his middle name on the notice of deficiency made it invalid; that he had never been to the Virgin Islands; and that he was not an American citizen   | Yes    | IRS      | \$5,000  |
| <i>Ernlé v. Comm’r</i> , T.C. Memo. 2010-237               | Taxpayer petitioned for redetermination of deficiency and failed to abide by the Court’s Rules and to stipulate all relevant matters; refused to testify; and delayed court proceedings by filing unnecessary motions and making unnecessary objections   | Yes    | IRS      | \$4,000  |
| <i>Fennel v. Comm’r</i> , T.C. Summ. Op. 2011-19           | Taxpayer petitioned for redetermination of deficiency and argued that his income was from a private corporation with no connection to the United States government  | Yes    | IRS      | \$2,250  |
| <i>Goff v. Comm’r</i> , 135 T.C. 231 (2010)                | Taxpayer petitioned for review of decision to proceed with collection and argued her debt had been paid by a bonded promissory note; refused to enter into a stipulation of facts; disobeyed the court’s order to submit a pretrial memorandum; and submitted claim that the court was a for-profit corporation   | Yes    | IRS      | \$15,000 |
| <i>Holmes v. Comm’r</i> , T.C. Memo. 2011-31               | Taxpayer petitioned for redetermination of deficiency and argued that his income is not taxable and that payment of federal income tax is voluntary   | Yes    | IRS      | \$75,000 |
| <i>Hyde v. Comm’r</i> , T.C. Memo. 2011-104                | Taxpayer petitioned for redetermination of deficiency and argued that the notice of deficiency did not conform to the Paperwork Reduction Act; that she is not liable for federal income tax because the tax laws are incomprehensible to her; and that the substitute for return created by the IRS is not valid because she did not authorize it  | Yes    | IRS      | \$3,000  |
| <i>Jensen v. Comm’r</i> , T.C. Memo. 2010-143              | Taxpayer petitioned for redetermination of deficiency and additions to tax and asserted frivolous arguments   | Yes    | TP       |          |

Table 9: Frivolous Issues Penalty Under IRC § 6673 and Related Appellate-Level Sanctions

| Case Citation   | Issue(s)  | Pro Se | Decision | Amount  |
|---|---|--------|----------|---|
| <i>Kubon v. Comm’r</i> , T.C. Memo. 2011-41, <i>appeal docketed</i> , No. 11-71592 (9th Cir. May 16, 2011)      | Taxpayers (H&W) petitioned for review of IRS decision to collect via levy and asserted frivolous arguments and consistently refused to participate in collection due process hearings                                 | Yes    | IRS      | \$20,000  |
| <i>Kuechenmeister v. Comm’r</i> , T.C. Summ. Op. 2010-161   | Taxpayer petitioned for review of IRS decision to collect via levy and asserted frivolous arguments   | Yes    | TP       |   |
| <i>Laszloffy v. Comm’r</i> , T.C. Memo. 2010-258  | Taxpayer petitioned for redetermination of deficiency, additions to tax, and penalties and argued that federal law does not apply to him, he is not a federal taxpayer, and federal income tax payments are voluntary | Yes    | IRS      | \$2,500   |
| <i>Mathews v. Comm’r</i> , T.C. Memo. 2010-226  | Taxpayer petitioned for redetermination of deficiency and additions to tax and asserted frivolous arguments, including that garnishment of his military retirement pay allowed him to exclude it from gross income    | Yes    | IRS      | \$500   |
| <i>Mattina v. Comm’r</i> , T.C. Memo. 2010-127, <i>appeal docketed</i> , No. 10-73032 (9th Cir. Sept. 27, 2010) | Taxpayer petitioned for review of IRS decision to collect via levy and asserted frivolous arguments including that the notice of deficiency was invalid because it did not say that the IRS had audited a return      | Yes    | IRS      | \$5,000   |
| <i>McLaurine v. Comm’r</i> , T.C. Memo. 2010-236  | Taxpayer petitioned for redetermination of deficiency and argued he was a citizen of the State of Alabama and not a United States citizen and therefore his income is from a foreign source and not taxable           | Yes    | IRS      | \$1,000   |
| <i>Mooney v. Comm’r</i> , T.C. Memo. 2011-35  | Taxpayer petitioned for redetermination of deficiency and additions to tax and argued that he lives in the Commonwealth of Virginia and works for a private corporation and is not subject to income tax              | Yes    | IRS      | \$2,000   |
| <i>Wheeler v. Comm’r</i> , T.C. Memo. 2010-188  | Taxpayer petitioned for redetermination of deficiency and additions to tax and asserted frivolous arguments   | Yes    | IRS      | \$25,000  |
| <i>Wnuck v. Comm’r</i> , 136 T.C. No. 24 (2011)   | Taxpayer petitioned for a redetermination of deficiency and argued wages not subject to income tax  | Yes    | IRS      | \$1,000 in bench opinion, \$5,000 when TP asked for reconsideration |
| <b>Business Taxpayers (Corporations, Partnerships, Trusts, and Sole Proprietorships – Schedules C, E, F)</b>    |   |        |          |   |
| <i>Christine v. Comm’r</i> , T.C. Memo. 2010-144  | Taxpayers (H&W) petitioned for redetermination of deficiency  | Yes    | TP       |   |
| <i>O’Boyle v. Comm’r</i> , T.C. Memo. 2010-149, <i>appeal docketed</i> , No. 11-11897 (11th Cir. Apr. 25, 2011) | Taxpayers (H&W) petitioned for redetermination of deficiency and additions to tax and asserted frivolous arguments  | Yes    | IRS      | \$45,000  |
| <i>Pace v. Comm’r</i> , T.C. Memo. 2010-272   | Taxpayer petitioned for redetermination of deficiency, additions to tax, and penalties and vigorously contested the Commissioner’s determination  | Yes    | TP       |   |
| <i>Tinnerman v. Comm’r</i> , T.C. Memo. 2010-150, <i>appeal docketed</i> (D.C. Cir. Oct. 12, 2010)              | Taxpayer petitioned for review of decision to proceed with collection and asserted frivolous arguments and refused to cooperate with stipulation of facts process   | No     | IRS      | \$25,000  |
| <b>Section 6673 Penalty Not Requested or Imposed but Taxpayer Warned To Stop Asserting Frivolous Arguments</b>  |   |        |          |   |
| <i>Forrest v. Comm’r</i> , T.C. Memo. 2010-263  | Taxpayer petitioned for redetermination of deficiency and additions to tax and delayed court proceedings  | Yes    |          |   |
| <i>Forrest v. Comm’r</i> , T.C. Memo. 2011-4  | Taxpayer petitioned for redetermination of deficiency and delayed court proceedings   | Yes    |          |   |
| <i>Glover v. Comm’r</i> , T.C. Memo. 2010-228   | Taxpayer petitioned for redetermination of deficiency and additions to income tax and argued that he transferred the income to a trust and therefore it was trust income rather than individual income                | Yes    |          |   |
| <i>Gregoline v. Comm’r</i> , T.C. Summ. Op. 2010-112  | Taxpayer petitioned for redetermination of deficiency and argued that his income is not taxable under the Constitution  | Yes    |          |   |
| <i>Grunsted v. Comm’r</i> , 136 T.C. No. 21 (2011)  | Taxpayer petitioned for review of decision to proceed with collection and asserted frivolous arguments, including that wages are not taxable  | Yes    |          |   |
| <i>Jeanmarie v. Comm’r</i> , T.C. Memo. 2010-281  | Taxpayers (H&W) petitioned for redetermination of deficiency and delayed court proceedings by filing unnecessary motions  | Yes    |          |   |
| <i>Lowery v. Comm’r</i> , T.C. Memo. 2010-167   | Taxpayer petitioned for redetermination of deficiency and asserted that her income did not come from a trade or business specifically enumerated in the IRC   | Yes    |          |   |

Table 9: Frivolous Issues Penalty Under IRC § 6673 and Related Appellate-Level Sanctions

| Case Citation   | Issue(s)  | Pro Se | Decision | Amount   |
|---|---|--------|----------|----------|
| <i>Oman v. Comm’r</i> , T.C. Memo. 2010-276   | Taxpayer petitioned for redetermination of deficiency and additions to tax and argued his wages were an exchange of property for property   | Yes    |          |          |
| <i>Smith v. Comm’r</i> , T.C. Memo. 2010-240, <i>appeal docketed</i> (10th Cir. Feb. 1, 2011)                     | Taxpayers (H&W) petitioned for redetermination of deficiency, additions to tax, and penalties, and delayed court proceedings  | Yes    |          |          |
| <i>Sullivan v. Comm’r</i> , T.C. Memo. 2010-138   | Taxpayer petitioned for redetermination of deficiency and asserted frivolous arguments, including that the amounts in the notice of deficiency were from illegal immigrants using the taxpayer’s social security number | Yes    |          |          |
| <i>Zigmont v. Comm’r</i> , T.C. Memo. 2010-253  | Taxpayer petitioned for review of decision to proceed with collection and assessment of penalties and asserted frivolous arguments  | Yes    |          |          |
| <b>US Courts of Appeals’ Decisions on Appeal of Section 6673 Penalties Imposed by US Tax Court</b>                |   |        |          |          |
| <i>Antolick v. Comm’r</i> , 107 A.F.T.R.2d (RIA) 1768 (11th Cir. 2011), <i>aff’g</i> Tax Ct. No. 21635-08L        | Penalty affirmed  | Yes    | IRS      | \$500    |
| <i>Avery v. Comm’r</i> , 399 Fed. Appx. 195 (9th Cir. 2010), <i>aff’g</i> Tax Ct. No. 17315-05                    | Penalty affirmed  | No     | IRS      | \$5,000  |
| <i>Deems v. Comm’r</i> , 107 A.F.T.R.2d (RIA) 2274 (11th Cir. 2011), <i>aff’g</i> Tax Ct. No. 1273-09L            | Penalty affirmed  | Yes    | IRS      | \$1,000  |
| <i>Miller-Wagenknecht v. Comm’r</i> , 385 Fed. Appx. 230 (3rd Cir.2010), <i>aff’g</i> Tax Ct. No. 11219-07        | Penalty affirmed  | Yes    | IRS      | \$1,000  |
| <i>Oropeza v. Comm’r</i> , 402 Fed. Appx. 221 (9th Cir. 2010), <i>aff’g</i> T.C. Memo. 2008-94                    | Penalty affirmed  | Yes    | IRS      | \$10,000 |
| <i>Thomason v. Comm’r</i> , 401 Fed. Appx. 921 (5th Cir. 2010), <i>aff’g</i> Tax Ct. No. 21182-08                 | Penalty affirmed  | Yes    | IRS      | \$2,000  |
| <i>White v. Comm’r</i> , 385 Fed. Appx. 95 (3rd Cir. 2010), <i>aff’g</i> Tax Ct. No. 7101-09L                     | Penalty affirmed  | Yes    | IRS      | \$10,000 |
| <b>U.S. Courts of Appeals’ Decisions on Sanctions Under Section 7482 (c)(4), FRAP Rule 38, or Other Authority</b> |   |        |          |          |
| <i>Walbaum v. Comm’r</i> , 387 Fed. Appx. 668 (8th Cir. 2010), <i>cert. denied</i> , 131 S. Ct. 1056 (2011)       | Taxpayer appealed Tax Court decision dismissing his petition for redetermination of deficiency and asserted frivolous arguments   | Yes    | IRS      | \$5,000  |

**Table 10 Charitable Deductions Under IRC § 170**

| Case Citation  | Issue(s)  | Pro Se | Decision |
|--|---|--------|----------|
| <b>Individual Taxpayers (But Not Sole Proprietorships)</b>   |   |        |          |
| <i>Ahmadian v. Comm'r</i> , T.C. Summ. Op. 2010-126  | TP failed to establish donee organization qualifies as a charitable organization under § 170  | No     | IRS      |
| <i>Bell v. Comm'r</i> , T.C. Summ. Op. 2011-54   | Substantiation  | Yes    | Split    |
| <i>De Werff v. Comm'r</i> , T.C. Summ. Op. 2011-29   | Substantiation  | Yes    | IRS      |
| <i>Evans v. Comm'r</i> , T.C. Memo. 2010-207   | Valuation of easement   | No     | IRS      |
| <i>Fessey v. Comm'r</i> , T.C. Memo. 2010-191  | Substantiation  | Yes    | IRS      |
| <i>Freedman v. Comm'r</i> , T.C. Memo. 2010-155  | Substantiation  | Yes    | IRS      |
| <i>Hendrix v. United States</i> , 106 A.F.T.R.2d (RIA) 5373 (S.D. Ohio 2010)   | Substantiation  | No     | IRS      |
| <i>Hollingsworth v. Comm'r</i> , T.C. Memo. 2010-262   | Substantiation  | Yes    | IRS      |
| <i>Igberaese v. Comm'r</i> , T.C. Memo. 2010-284   | Substantiation  | Yes    | IRS      |
| <i>Kaufman v. Comm'r</i> , 136 T.C. No. 13 (2010)  | TP's donated facade easement was not protected in perpetuity pursuant to 26 C.F.R. § 1.170A-14(g)(6). Cash payments were not deductible in 2003, but were deductible in 2004. | No     | Split    |
| <i>Lang v. Comm'r</i> , T.C. Memo 2010-152   | Substantiation  | Yes    | IRS      |
| <i>Murphy v. Comm'r</i> , T.C. Memo. 2010-264  | Substantiation  | Yes    | IRS      |
| <i>Roberts v. Comm'r</i> , T.C. Summ. Op. 2010-76  | Substantiation  | Yes    | IRS      |
| <i>Rolfs v. Comm'r</i> , 135 T.C. 471 (2010)   | TP received a substantial benefit in exchange for donation; failed to show value of the property donated exceeded value of the benefit received                               | No     | IRS      |
| <i>Scheidelman v. Comm'r</i> , T.C. Memo. 2010-151   | TP failed to establish fair market value of donated property required under 26 C.F.R. § 1.170A-13(c)  | No     | Split    |
| <i>Schrimsher v. Comm'r</i> , T.C. Memo 2011-71  | Substantiation  | No     | IRS      |
| <i>Smith v. Comm'r</i> , T.C. Memo. 2010-162   | Substantiation  | Yes    | IRS      |
| <i>Towell v. Comm'r</i> , T.C. Summ. Op. 2010-141  | Substantiation  | Yes    | IRS      |
| <i>Viralam v. Comm'r</i> , 136 T.C. No. 8 (2011)   | TP not entitled to deduction because retained dominion and control over stocks transferred to charitable foundation; Substantiation   | NO     | IRS      |
| <i>Williams v. Comm'r</i> , T.C. Summ. Op. 2010-86   | Substantiation  | Yes    | IRS      |
| <i>Williams v. Comm'r</i> , T.C. Memo 2011-89  | TP was entitled to charitable deductions for his basis in donated artwork, not entitled to deduct excess.   | No     | IRS      |
| <b>Business Taxpayers (Corporations, Partnerships, Trusts, and Sole Proprietorships – Schedules C, E, F)</b>           |   |        |          |
| <i>1982 East, LLC v. Comm'r</i> , T.C. Memo. 2011-84   | Donated property not a qualified conservation contribution because it failed to meet the requirements of § 170(h)(4) and (5).   | No     | IRS      |
| <i>Boltar, LLC v. Comm'r</i> , 136 T.C. No. 14 (2011)  | Valuation of easement   | No     | IRS      |
| <i>Ognibene v. Comm'r</i> , T.C. Summ. Op. 2010-131  | Substantiation  | Yes    | IRS      |
| <i>Saunders v. Comm'r</i> , T.C. Summ. Op. 2010-138  | Substantiation  | No     | IRS      |
| <i>Trout Ranch, LLC v. Comm'r</i> , T.C. Memo 2010-283, <i>appeal docketed</i> , No. 11-9006 (10th Cir. Mar. 21, 2011) | Valuation of easement   | No     | Split    |
| <i>Whitehouse Hotel LP v. Comm'r</i> , 615 F.3d 321 (5th Cir. 2010)  | Valuation of easement   | No     | Split    |

## Acronym Glossary — Annual Report to Congress 2011

| Acronym | Definition   |
|---------|--|
| AARS    | Appeals Account Resolution Specialist                        |
| ABA     | American Bar Association                                     |
| ACDS    | Appeals Centralized Database System                          |
| ACH     | Automated Clearinghouse                                      |
| ACM     | Appeals Case Memoranda                                       |
| ACS     | Automated Collection System                                  |
| ACSS    | Automated Collection System Support                          |
| ACTC    | Additional Child Tax Credit or Advance Child Tax Credit      |
| ADA     | Americans With Disabilities Act                              |
| ADR     | Alternative Dispute Resolution or Address Research System    |
| AGI     | Adjusted Gross Income  |
| AIA     | Anti-Injunction Act  |
| AICPA   | American Institute of Certified Public Accountants           |
| AIS     | Automated Insolvency System                                  |
| AJCA    | American Jobs Creation Act of 2004                           |
| AIMS    | Audit Information Management System                          |
| ALE     | Allowable Living Expenses                                    |
| ALS     | Automated Lien System  |
| AM      | Accounts Management  |
| AMS     | Accounts Management System                                   |
| AMT     | Alternative Minimum Tax                                      |
| AMTAP   | Accounts Management Taxpayer Assurance Program               |
| ANMF    | Automated Non Master File                                    |
| AQR     | Automated Questionable Refund                                |
| ANPR    | Advance Notice of Proposed Rulemaking                        |
| AO/SO   | Appeals or Settlement Officer                                |
| AOIC    | Automated Offer In Compromise                                |
| APA     | American Payroll Association or Administrative Procedure Act |
| APS     | Appeals Processing Service                                   |
| AQC     | Automated Questionable Credits                               |
| AQMS    | Appeals Quality Management System                            |
| ARAP    | Accelerated Revenue Assurance Program                        |
| ARC     | Annual Report to Congress                                    |
| ARRA    | America Recovery and Reinvestment Act                        |
| ASA     | Average Speed of Answer                                      |
| ASED    | Assessment Statute Expiration Date                           |
| ASFR    | Automated Substitute for Return                              |
| ATAO    | Application for Taxpayer Assistance Order                    |
| ATFRS   | Automated Trust Fund Recovery System                         |

| Acronym | Definition                                     |
|---------|--|
| ATIN    | Adoption Taxpayer Identification Number        |
| ATP     | Abusive Transaction Program                    |
| AUR     | Automated Underreporter                        |
| AWSS    | Agency Wide Shared Services                    |
| BIR     | Bureau of Internal Revenue                     |
| BMF     | Business Master File                           |
| BOSS    | Bond and Option Sales Strategy                 |
| BNA     | Bureau of National Affairs                     |
| BPR     | Business Performance Review                    |
| BRTF    | Business Returns Transaction File              |
| BTA     | Board of Tax Appeals                           |
| CADE2   | Customer Account Data Engine 2                 |
| CAF     | Centralized Authorization File                 |
| CAP     | CAWR Automated Program                         |
| CARE    | Customer Assistance, Relationships & Education |
| CAS     | Customer Account Services                      |
| CAWR    | Combined Annual Wage Reporting                 |
| CBO     | Congressional Budget Office                    |
| CBPP    | Center on Budget & Policy Priorities           |
| CBRS    | Currency & Banking Retrieval System            |
| CC      | Chief Counsel (Office of)                      |
| CCB     | Check Claims Branch                            |
| CCISO   | Cincinnati Campus Innocent Spouse Operations   |
| CCP     | Centralized Case Processing                    |
| CDP     | Collection Due Process                         |
| CDPTS   | Collection Due Process Tracking System         |
| CDE     | Compliance Data Environment                    |
| CDW     | Compliance Data Warehouse                      |
| CEAS    | Correspondence Examination Automation Support  |
| CFF     | Collection Field Function                      |
| CFIF    | Check Forgery Insurance Fund                   |
| CI      | Criminal Investigation (Division)              |
| CIP     | Compliance Initiative Project                  |
| CIQMS   | Complex Interest Quality Management System     |
| CIS     | Correspondence Imaging System                  |
| CLD     | Communications, Liaison and Disclosure         |
| CNC     | Currently Not Collectible                      |
| COBRA   | Consolidated Omnibus Budget Reconciliation Act |
| CODI    | Cancellation Of Debt Income                    |

| Acronym | Definition  |
|---------|---|
| COIC    | Centralized Offer In Compromise                             |
| COTR    | Contract Officer Technical Representative                   |
| CONOPS  | Concept of Operations                                       |
| CPE     | Continuing Professional Education                           |
| CPS     | Collection Process Study                                    |
| CQMS    | Collection Quality Management System                        |
| CRIS    | Compliance Research Information System                      |
| CSCO    | Compliance Services Collection Operations                   |
| CSED    | Collection Statute Expiration Date                          |
| CSI     | Campus Specialization Initiative                            |
| CSR     | Customer Service Representative                             |
| CTC     | Child Tax Credit  |
| DA      | Disclosure Authorization                                    |
| DAC     | Disability Access Credit                                    |
| DART    | Disaster Assistance Review Team                             |
| DATC    | Doubt As To Collectibility                                  |
| DATL    | Doubt As To Liability                                       |
| DCIA    | Debt Collection Improvement Act (of 1996)                   |
| DCCP    | Debit and Credit Card Payment                               |
| DD      | Direct Deposit  |
| DDb     | Dependent Data Base   |
| DDIA    | Direct Deposit Installment Agreement                        |
| DDP     | Daily Delinquency Penalty                                   |
| DFO     | Designated Federal Official                                 |
| DI      | Desktop Integration or Debt Indicator                       |
| DIF     | Discriminant Income Function                                |
| DJA     | Declaratory Judgment Act                                    |
| DLN     | Document Locator Number                                     |
| DMF     | Death Master File   |
| DOD     | Department of Defense                                       |
| DOJ     | Department of Justice                                       |
| DoMA    | Defense of Marriage Act                                     |
| EA      | Enrolled Agent  |
| EAJA    | Equal Access to Justice Act                                 |
| EAR     | Electronic Account Resolution                               |
| EBE     | Employee Business Expense                                   |
| EBT     | Electronic Benefits Transfer                                |
| ECS     | Enterprise Collections Strategy                             |
| EGTRRA  | Economic Growth and Tax Relief Reconciliation Act (of 2001) |
| EFDS    | Electronic Fraud Detection Center                           |
| EFTPS   | Electronic Federal Tax Payment System                       |

| Acronym | Definition   |
|---------|--|
| EFW     | Electronic Funds Withdrawal                          |
| EIC     | Earned Income Credit                                 |
| EIN     | Employer Identification Number                       |
| EITC    | Earned Income Tax Credit                             |
| ELMS    | Enterprise Learning Management System                |
| ELS     | Electronic Lodgment Service                          |
| ERIS    | Enforcement Revenue Information System               |
| EO      | Exempt Organization                                  |
| EP      | Employee Plans                                       |
| EQRS    | Embedded Quality Review System                       |
| ERIS    | Enforcement Revenue Information System               |
| ERO     | Electronic Return Originator                         |
| ERISA   | Employee Retirement Income Security Act              |
| ERSA    | Employee Retirement Savings Account                  |
| ES      | Estimated Tax Payments                               |
| ESA     | Economic Stimulus Act                                |
| ESL     | English as a Second Language                         |
| ESOP    | Employee Stock Ownership Plan                        |
| ESP     | Economic Stimulus Payment                            |
| ETA     | Effective Tax Administration                         |
| ETAAC   | Electronic Tax Administration Advisory Committee     |
| ETARC   | Electronic Tax Administration and Refundable Credits |
| ETLA    | Electronic Tax Law Assistance                        |
| FA      | Field Assistance                                     |
| FAFSA   | Free Application for Financial Student Aid           |
| FATCA   | Foreign Account Tax Compliance Act                   |
| FBAR    | Foreign Bank Account Report                          |
| FBU     | Federal Benefits Unit                                |
| FCR     | Federal Case Registry                                |
| FCRA    | Fair Credit Reporting Act                            |
| FDCPA   | Fair Debt Collection Practices Act                   |
| FDIC    | Federal Deposit Insurance Corporation                |
| FEIE    | Foreign Earned Income Exclusion                      |
| FEMA    | Federal Emergency Management Agency                  |
| FICA    | Federal Insurance Contribution Act                   |
| FMV     | Fair Market Value                                    |
| FMS     | Financial Management Service                         |
| FOIA    | Freedom Of Information Act                           |
| FPAA    | Final Partnership Administrative Adjustment          |
| FPLP    | Federal Payment Levy Program                         |
| FRA     | Federal Records Act                                  |

| Acronym | Definition  |
|---------|---|
| FLSA    | Fair Labor Standards Act                                      |
| FSRP    | Facilitated Self-Assistance Research Project                  |
| FTA     | First-Time Abatement or Forum on Tax Administration           |
| FTC     | Federal Trade Commission or Foreign Tax Credit                |
| FTD     | Federal Tax Deposit or Failure To Deposit                     |
| FTE     | Full Time Equivalent  |
| FTF     | Failure To File   |
| FTHBC   | First-Time Homebuyer Credit                                   |
| FTI     | Federal Tax Information                                       |
| FTL     | Federal Tax Lien  |
| FTP     | Failure To Pay  |
| FTS     | Fast Track Settlement   |
| FUTA    | Federal Unemployment Tax                                      |
| FY      | Fiscal Year   |
| GCCF    | Gulf Coast Claims Facility                                    |
| GCI     | Geographic Coverage Initiative                                |
| GCM     | General Counsel Memorandum                                    |
| GLD     | Governmental Liaison and Disclosure                           |
| GE      | Government Entities   |
| GAO     | Government Accountability Office or General Accounting Office |
| HCTC    | Health Coverage Tax Credit                                    |
| HERA    | Housing and Economic Recovery Act                             |
| IA      | Installment Agreement   |
| IAT     | Integrated Automation Technology                              |
| ICAS    | Internet Customer Account Services                            |
| ICP     | Integrated Case Processing                                    |
| ICS     | Integrated Collection System                                  |
| IDAP    | IDRS Decision Assisting Program                               |
| IRDM    | Information Reporting and Document Matching                   |
| IDFP    | IRS Directory for Practitioners                               |
| IDRS    | Integrated Data Retrieval System                              |
| IDS     | Inventory Delivery System                                     |
| IMD     | Internal Management Document                                  |
| IMF     | Individual Master File  |
| IMRS    | Issue Management Resolution System                            |
| IPM     | Integrated Production Model                                   |
| IPOC    | International Planning and Operations Council                 |
| IP PIN  | Identity Protection Personal Identification Number            |
| IPSU    | Identity Protection Specialized Unit                          |
| IRB     | Internal Revenue Bulletin                                     |
| IRC     | Internal Revenue Code   |

| Acronym | Definition  |
|---------|---|
| IRM     | Internal Revenue Manual                                 |
| IRMF    | Information Returns Master File                         |
| IRP     | Information Returns Processing                          |
| IRPTR   | Information Returns Processing Transcript Requests      |
| IRS     | Internal Revenue Service                                |
| IRSAC   | Internal Revenue Service Advisory Council               |
| IRSN    | Internal Revenue Service Number                         |
| ITAAG   | Identity Theft Assessment and Action Group              |
| ITAR    | Identity Theft Assistance Request                       |
| ITIN    | Individual Taxpayer Identification Number               |
| JCT     | Joint Committee on Taxation                             |
| JGTRA   | Jobs and Growth Tax Relief Reconciliation Act (of 2003) |
| JOC     | Joint Operations Center                                 |
| LB&I    | Large Business and International Operating Division     |
| LCCI    | Last Chance Compliance Initiative                       |
| LCTU    | Large Corporation Technical Unit                        |
| LEM     | Law Enforcement Manual                                  |
| LEP     | Limited English Proficiency                             |
| LIF     | Low Income Filter                                       |
| LIHTC   | Low Income Housing Tax Credit                           |
| LILO    | Lease-In Lease-Out                                      |
| LITC    | Low Income Taxpayer Clinic                              |
| LLC     | Limited Liability Company                               |
| LLP     | Limited Liability Partnership                           |
| LOS     | Level of Service  |
| LP      | Limited Partnership                                     |
| LSB     | Language Services Branch                                |
| LTA     | Local Taxpayer Advocate                                 |
| M&P     | Media and Publications                                  |
| MAGI    | Modified Adjusted Gross Income                          |
| MFDR    | Mortgage Forgiveness Debt Relief Act                    |
| MFT     | Master File Tax   |
| MIRSA   | My IRS Account Application                              |
| MITS    | Modernization and Information Technology Services       |
| MLI     | Multilingual Initiative or Most Litigated Issue         |
| MWP     | Making Work Pay Credit                                  |
| NAEA    | National Association of Enrolled Agents                 |
| NCOA    | National Change of Address                              |
| NFTL    | Notice of Federal Tax Lien                              |
| NMF     | Non-Master File   |
| NOD     | Notice of Deficiency                                    |

| Acronym | Definition  |
|---------|---|
| NPS     | National Print Site   |
| NQRS    | National Quality Review System  |
| NRP     | National Research Program   |
| NTA     | National Taxpayer Advocate  |
| OAR     | Operations Assistance Request   |
| OBRA    | Omnibus Budget Reconciliation Act (of 1990)                                 |
| OD      | Operating Division  |
| OIC     | Offer in Compromise   |
| OECD    | Organisation for Economic Co-Operation and Development                      |
| OMB     | Office of Management and Budget   |
| OMM     | Operation Mass Mail   |
| OPERA   | Office of Program Evaluation, Research, & Analysis                          |
| OPI     | Office of Penalty and Interest Administration or Over the Phone Interpreter |
| OSI     | Office of Servicewide Interest  |
| OPR     | Office of Professional Responsibility                                       |
| OSP     | Office of Servicewide Penalties   |
| OTA     | Office of Tax Analysis  |
| OTBR    | Office of Taxpayer Burden Reduction   |
| OTP     | Office of Tax Policy  |
| OUO     | Official Use Only   |
| OVC     | Office for Victims of Crime   |
| OVCI    | Offshore Voluntary Compliance Initiative                                    |
| OVDP    | Offshore Voluntary Disclosure Program                                       |
| OWI     | Office of War Information   |
| PCA     | Private Collection Agency   |
| PCAOB   | Public Company Accounting Oversight Board                                   |
| PCI     | Potentially Collectible Inventory   |
| PDC     | Private Debt Collection   |
| PFA     | Pre-Filing Agreement  |
| PGLD    | Privacy, Governmental Liaison and Disclosure (Office of)                    |
| PIC     | Primary Issue Code  |
| PNI     | Potential New Inventory   |
| PLR     | Private Letter Ruling   |
| POA     | Power Of Attorney   |
| POP     | Phone Optimization Project  |
| PPA     | Pension Protection Act (of 2006)  |
| PPACA   | Patient Protection and Affordable Care Act                                  |
| PPIA    | Partial Payment Installment Agreement                                       |
| PPS     | Practitioner Priority Service   |
| PRA     | Paperwork Reduction Act   |

| Acronym | Definition  |
|---------|---|
| PRP     | Problem Resolution Program  |
| PRWORA  | Personal Responsibility and Work Opportunity Reconciliation Act (of 1996) |
| PSC     | Philadelphia Service Center   |
| PREA    | Premature Referral and Acceptance   |
| PTIN    | Preparer Tax Identification Number  |
| PY      | Processing Year   |
| QBU     | Qualified Business Unit   |
| QETP    | Questionable Employment Tax Practices                                     |
| QRP     | Questionable Refund Program   |
| RA      | Revenue Agent   |
| RAC     | Refund Anticipation Check   |
| RAL     | Refund Anticipation Loan  |
| RCA     | Reasonable Cause Assistant  |
| RCP     | Reasonable Collection Potential   |
| RGS     | Report Generating Software  |
| RICS    | Return Integrity and Correspondence Services                              |
| RO      | Revenue Officer   |
| ROFT    | Record of Federal Tax Liability   |
| ROI     | Return on Investment  |
| ROTERS  | Records of Tax Enforcement Results  |
| RPS     | Revenue Protection Strategy   |
| RRA 98  | (Internal Revenue Service) Restructuring and Reform Act of 1998           |
| RPC     | Return Preparer Coordinator   |
| RPS     | Revenue Protection Strategy   |
| RPP     | Return Preparer Program   |
| RRP     | Return Review Program   |
| RSED    | Refund Statute Expiration Date  |
| SAMS    | Systemic Advocacy Management System                                       |
| SAR     | Strategic Assessment Report   |
| SARP    | State Audit Report Program  |
| SBA     | Small Business Administration   |
| SBDC    | Small Business Development Center   |
| SB/SE   | Small Business/Self-Employed Operating Division                           |
| SBJPA   | Small Business Job Protection Act   |
| SEC     | Securities and Exchange Commission  |
| SEP     | Special Enforcement Program   |
| SERP    | Servicewide Electronic Research Program                                   |
| SFR     | Substitute for Return   |
| SL      | Stakeholder Liaison   |
| SLA     | Service Level Agreement   |

| Acronym | Definition  |
|---------|---|
| SNOD    | Statutory Notice of Deficiency                                    |
| SO      | Settlement Officer  |
| SOI     | Statistics of Income  |
| SP      | Submission Processing   |
| SPC     | Submission Processing Center(s)                                   |
| SPDER   | Office of Servicewide Policy, Directives, and Electronic Research |
| SPEC    | Stakeholder Partnerships, Education & Communication               |
| SPOC    | Single Point of Contact   |
| SSA     | Social Security Administration                                    |
| SSI     | Supplemental Security Income                                      |
| SSN     | Social Security Number  |
| STC     | Student Tax Clinic  |
| STO     | Student Tuition Organization                                      |
| SVC     | Stored Value Card   |
| TAB     | Taxpayer Assistance Blueprint                                     |
| TAC     | Taxpayer Assistance Center  |
| TACT    | Taxpayer Communications Taskgroup                                 |
| TAD     | Taxpayer Advocate Directive                                       |
| TAMIS   | Taxpayer Advocate Management Information System                   |
| TAMRA   | Technical and Miscellaneous Revenue Act (of 1988)                 |
| TANF    | Temporary Assistance to Needy Families                            |
| TAO     | Taxpayer Assistance Order   |
| TAP     | Taxpayer Advocacy Panel   |
| TAS     | Taxpayer Advocate Service   |
| TASIS   | Taxpayer Advocate Service Integrated System                       |
| TBOR    | Taxpayer Bill of Rights   |
| TC      | Transaction Code  |
| TCE     | Tax Counseling for the Elderly                                    |
| TDA     | Taxpayer Delinquent Account                                       |
| TDRA    | Tip Rate Determination Agreement                                  |
| TDI     | Taxpayer Delinquent Investigation                                 |
| TE      | Tax Examiner or Tax Exempt  |
| TEFRA   | Tax Equity and Fiscal Responsibility Act (of 1982)                |
| TEC     | Taxpayer Education and Communication                              |
| TE/GE   | Tax Exempt & Government Entities Operating Division               |

| Acronym | Definition   |
|---------|--|
| TEFRA   | Tax Equity and Fiscal Responsibility Act                 |
| TEI     | Tax Executives Institute                                 |
| TFP     | Tax Forms & Publications                                 |
| TFRP    | Trust Fund Recovery Penalty                              |
| TIGTA   | Treasury Inspector General for Tax Administration        |
| TIN     | Taxpayer Identification Number                           |
| TIPRA   | Tax Increase Prevention and Reconciliation Act (of 2005) |
| TOP     | Treasury Offset Program                                  |
| TOS     | Terms of Service   |
| TPNC    | Taxpayer Notice Code                                     |
| TPP     | Third Party Payer  |
| TPPA    | Third Party Payroll Agent                                |
| TRA     | Tax Reform Act   |
| TRHCA   | Tax Relief and Health Care Act (of 2006)                 |
| TTB     | (Alcohol and Tobacco) Tax and Trade Bureau               |
| TY      | Tax Year   |
| UAA     | Undeliverable As Addressed                               |
| UAL     | Uniform Acknowledgement Letter                           |
| UCR     | Uniform Call Routing                                     |
| UDOC    | Uniform Definition of a Child                            |
| UPU     | Universal Postal Union                                   |
| URF     | Unidentified Remittances File                            |
| URP     | Underreporter  |
| USPS    | United States Postal Service                             |
| USPTO   | United States Patent and Trademark Office                |
| UWR     | Uniform Work Request                                     |
| VAT     | Value Added Tax  |
| VITA    | Volunteer Income Tax Assistance                          |
| VSD     | Virtual Service Delivery                                 |
| VTO     | Virtual Translation Office                               |
| W & I   | Wage and Investment Operating Division                   |
| WFTRA   | Working Families Tax Relief Act                          |
| WO      | Whistleblower Office                                     |
| XSF     | Excess Collection File                                   |
| XSFTG   | Excess Collection File Task Group                        |

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